

# Quarterly Insight

Johnson Private Client Group | Johnson Trust Company | Johnson Institutional Management

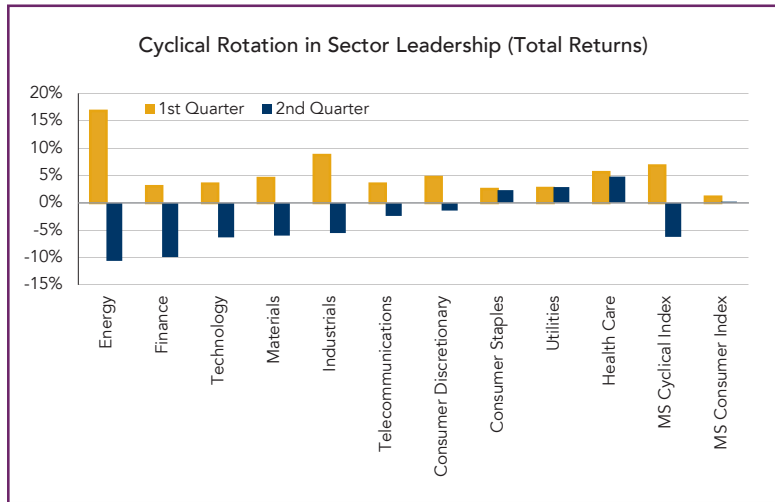


Second Quarter 2011

## Market Update

A softer batch of economic news and renewed anxiety about European credit markets let some of the air out of the stock market's balloon in the second quarter. The S&P 500 Index had to stage a comeback in late June just to break even for the quarter. Smaller companies ended the period down slightly. The resilient domestic bond market, however, returned 2.3% for the quarter, as cautious global investors turned to U.S. bonds as a safe haven.

A noticeable shift occurred this spring as investors took profits in the more cyclical sectors of the stock market. Areas with more consistent earnings and higher dividend yields, such as Health Care, Consumer Staples, and Utilities sectors produced positive returns. While investors' risk appetites have waned recently, the rotation in sector leadership has been fairly orderly, and the market has avoided a broad, deep correction this year.



Despite the economic soft patch, it is our expectation that economic growth will pick up the remainder of the year. The Japanese earthquake and tsunami in March created a major disruption in the supply chain for the auto and manufacturing industries, but that is temporary in nature. The tax package from last December also provides incentive for capital investment prior

to year-end. Inflation pressures have cooled with oil prices falling 20% from their peak, and most other key input prices declining meaningfully. This should benefit consumers and producers alike. The Federal Reserve's quantitative easing (QE2) program ceased on June 30th. This initiative did boost asset prices, so there was initial concern that markets would decline when it came to an end. However, there is little evidence that QE2 contributed much to economic growth, and its termination was long scheduled, giving investors plenty of time to react.

For stocks, much of their success over the past two years can be explained by rising earnings. Corporate earnings have increased slightly faster than stock prices, making valuation (as measured by the price/earnings ratio) actually lower. Recently, though, a disconnect has emerged between Wall Street's consensus forecasts for earnings and its assessment of GDP growth.

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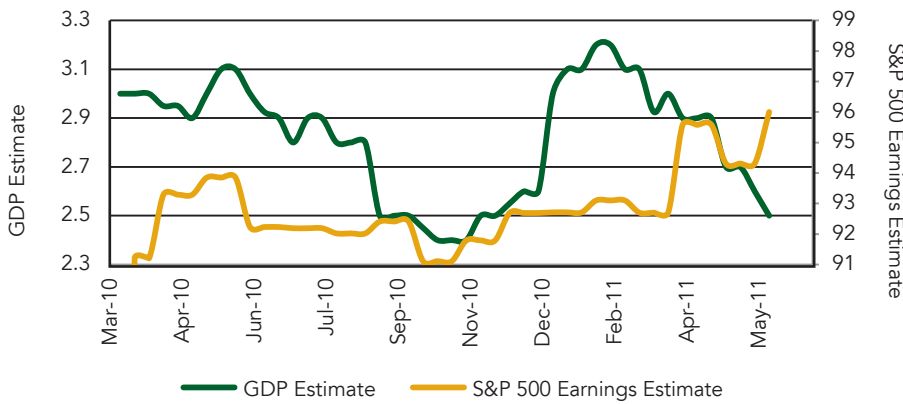
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### TOTAL RETURN

Quarter Ending June 30, 2011

S&P 500	0.1%
Dow Jones Industrial Average	1.4%
NASDAQ	0.0%
Russell 2000	-1.6%
MSCI EAFE (International)	1.8%
Barclays Aggregate Bond Index	2.3%

Lower GDP Estimates Could Pressure Earnings Estimates



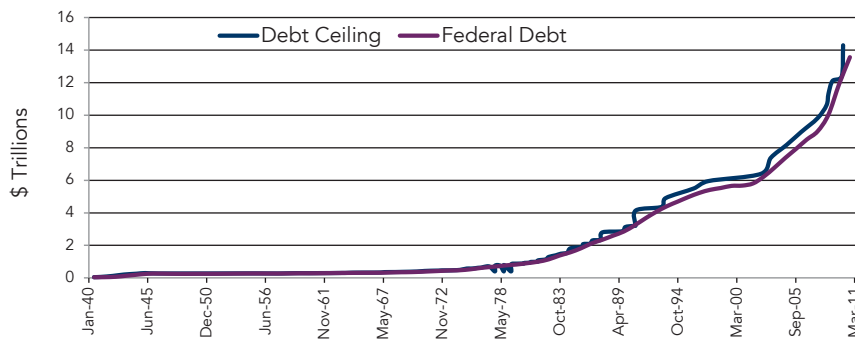
Although we expect economic improvement during the second half of the year, we believe the estimates for future earnings growth this year might prove to be too optimistic, since they have not sufficiently adjusted for the first half's slower growth. It will also be difficult to squeeze more earnings growth from profit margins, which are currently very high. A slower pace of

earnings growth should not completely surprise investors. Our stock return expectations are below average but are still more appealing than potential bond returns.

Greece continues to be the epicenter of European credit problems. The International Monetary Fund, the European Central Bank, and the European Union are trying to coordinate efforts to keep Greece from defaulting on its debt, but it has not been able to meet the goals that were established in previous bailouts. Bond rating agencies have warned of government debt default, which would impair capital positions at banks around Europe and the world. The stakes are high for the European Union, and we would expect a temporary solution in the near-term. However, it is almost certain that Greece will need a second bailout package as soon as next year, and it seems inconceivable that the political will is there to allow that. This is a risky situation with a potential for a broader domino effect of stressed global bank capital positions, and we have been careful to minimize the risk exposure in portfolios.

The U.S. is certainly not the poster child for fiscal health either. This summer, the federal debt will hit its mandated ceiling (currently capped at \$14.3 trillion) and absent Congressional action to raise it, the government will run short in its ability to pay its bills by August. The urgency of the fiscal situation was highlighted by S&P's Ratings Services, which recently suggested that a downgrade in the creditworthiness of U.S. Treasuries could result if policymakers cannot reverse the fiscal deterioration.

Debt Ceiling Has Been Raised 84 Times Since 1940



Necessity is the mother of invention, and politicians in Washington have been scrambling to reach agreement on the debt limit and address the unsustainable path that our fiscal policy has followed. Over the next decade, there seems to be general bipartisan agreement that the deficit needs to be reduced by at least \$4 trillion. There is wide disagreement about how to achieve this, and negotiations are fluid and subject to political whim. We expect a deal could involve a combination of spending cuts of \$1-2 trillion over the next decade and perhaps some cuts in specific corporate tax breaks. In this base case, taxes wouldn't be explicitly raised, entitlement and health care programs would not be touched, and some short-term economic stimulus ideas like a payroll tax cut extension could be added as a sweetener to help the economy in the short-run. This is a more politically "safe" approach. Longer-term, "kicking the can" has repercussions, as we see with our neighbors across the pond. While we are encouraged that there is more debate on the subject, more drastic action will be needed to get our country back on a sustainable fiscal path.

# The Role of Absolute Return Investments

Johnson Investment Counsel is incorporating absolute return investments within client portfolios as an alternative asset class to both traditional stocks and bonds where appropriate. These investments consist of a variety of strategies with the objective of generating positive absolute returns that are less correlated to the traditional markets. These strategies include forms of arbitrage, opportunistic debt and hedging of stock market exposure. While some of these approaches may seem unfamiliar, they are actually an effective tool for risk management in the context of a diversified portfolio.

As an alternative to bonds, absolute return strategies serve the purpose of managing the risks of rising interest rates and inflation. Over the last 30 years, bond investors have had the tailwind of a declining interest rate environment. Since the early 1980s, we have experienced an historic bull market in bond returns. The 10-Year U.S. Treasury yield back then was around 15%. Today it is around 3%, providing a small cushion against the potential for rising interest rates. At this level, bonds will struggle to generate positive inflation-adjusted total returns. The absolute return vehicles we employ have the flexibility to use various investment strategies that can add value in a rising interest rate environment. One of the strategies, merger arbitrage, naturally benefits from rising interest rates.

As an alternative to equities, absolute return strategies can reduce overall portfolio volatility and limit the magnitude of declines by focusing on risk-adjusted returns and capital preservation. One statistical measure of volatility that assists us in evaluating risk is known as beta. Beta is simply a measure of an investment's volatility in relation to a certain market. For example, an investment strategy with a beta of 1.20 to the equity market indicates that the strategy has historically been 20% more volatile than the market. The absolute return strategies we are using in our clients' portfolios have very low historical betas to both the equity and bond markets, are managed conservatively with a focus on risk-adjusted returns and capital preservation, and are closer to bonds on the volatility spectrum. Low betas are an indication that managers of these strategies are seeking out and generating return opportunities that are not necessarily dependent on which way the stock or bond markets are moving.

Understanding Volatility and Total Return

Year	Arbitrage Fund	Absolute Strategies Fund	S&P 500 Index
2006	6.1%	6.8%	15.8%
2007	7.5%	5.1%	5.5%
2008	-0.6%	-13.5%	-37.0%
2009	10.2%	18.5%	26.5%
2010	1.8%	4.2%	15.1%
Annualized Total Return	4.9%	3.7%	2.3%
Cumulative Total Return	27.1%	19.9%	12.0%

*Returns are net of expenses for the Arbitrage Fund (ARBFX) and the Absolute Strategies Fund (ASFIX).*

The historical effects of lower volatility on a portfolio's compounded total return are illustrated in the table to the left. Two absolute return mutual funds, Arbitrage Fund and Absolute Strategies Fund, are compared to the S&P 500 Index. While the two funds lagged the index when stocks performed well, they provided more downside protection when stocks faltered in 2008. Protecting against the large decline has proven to be more beneficial in compounding wealth over time.

Absolute return strategies are often associated with hedge funds, but this is often misleading. Hedge funds are investment structures that are typically illiquid, lack transparency and independent custodianship, have high

expenses, and usually make use of leverage. However, the absolute return investments we utilize for clients are in the form of the familiar mutual fund structure with daily liquidity, portfolio transparency and independent custody of assets held by a bank, very little or no leverage, and moderate, flat fees. Many of these managers previously were only accessible to institutional or qualified investors in a limited partnership structure.

In the current environment of low yields and less compelling valuation levels across asset classes, our return expectations for the absolute return strategies we are using are in the mid-single digits net of manager expenses. While unexciting, we believe this is attractive in risk-adjusted terms and can add value in many portfolios.

## Joel Siefert Joins Dayton Office



We have recently added a new Portfolio Manager to our Dayton office, Joel Siefert. Joel holds the Chartered Financial Analyst designation and, prior to joining Johnson, he was a Senior Portfolio Manager with Key Bank.

Joel is a member of the Dayton Society of Financial Analysts and is involved in various community organizations, including the Alzheimer's Association, Habitat for Humanity and his church. Joel and his wife, Mindy, live in Englewood and have two children, Kara and Luke.

"I am very pleased to join the Johnson Investment Counsel team and serve our clients in the Dayton community. I really appreciate the JIC culture and the client-centered focus. I believe JIC has a tremendous growth opportunity in the Dayton region, and I look forward to contributing to that in the years to come."

## 13th Annual Voices of Giving Awards Ceremony

Johnson Investment Counsel was recognized at the Voices of Giving Awards Ceremony, presented by the Greater Cincinnati Planned Giving Council. Tim Johnson accepted the award on behalf of the firm and was also recognized for his efforts to educate clients about the benefits of leaving bequests to charity.

Over a quarter of a billion dollars is held in 365 charitable trusts, endowments, foundations and other charitable accounts that have been directed to charity by Johnson Investment Counsel's clients. We would like to say thank you to our clients for sharing our interest in charitable giving and for impacting the lives of so many across various communities.

## Top Workplaces Award

Johnson Investment Counsel was named as one of Cincinnati's Top Workplaces in 2011 by Enquirer Media. This list was published in the June 19th edition of *The Cincinnati Enquirer*. JIC is ranked seventh out of 40 other small companies who made the list. A total of 74 small companies were evaluated on 6 different factors and JIC was among the top 10 in all 6 categories.



**ENQUIRER MEDIA**  
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Johnson Investment Counsel values your trust, loyalty and "word of mouth" endorsements. We welcome your introductions to the people in your life you care about such as family, friends, neighbors, professionals and business associates.

## About Us

Johnson Investment Counsel, Inc. is Greater Cincinnati's largest independent wealth management firm, managing \$6 billion in assets. Johnson Investment Counsel is an employee-owned firm, offering a full range of fee-based, integrated wealth management services, including: investment portfolios, education and retirement planning, cash management, estate planning, trust services, charitable giving, mutual funds, 401(k) plans, IRAs and more. Johnson Investment Counsel has built strong, long-term relationships with individuals and families, charitable organizations, foundations and corporations through three divisions: Johnson Private Client Group, Johnson Institutional Management and Johnson Trust Company, the only independent trust company in Greater Cincinnati.

### DIVISIONS

- Johnson Private Client Group
- Johnson Trust Company
- Johnson Institutional Management

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### OFFICES

CINCINNATI  
3777 West Fork Road  
Cincinnati, OH 45247  
Phone: 513.661.3100  
Toll Free: 800.541.0170  
Fax: 513.661.3160

COLUMBUS  
100 E. Broad Street, Suite 2300  
Columbus, OH 43215  
Phone: 614.365.9103  
Toll Free: 866.365.4523  
Fax: 614.365.9943

DAYTON  
40 North Main Street, Suite 2110  
Dayton, OH 45423  
Phone: 937.461.3790  
Toll Free: 800.851.9114  
Fax: 937.461.2969

[www.johnsoninv.com](http://www.johnsoninv.com)

