

# Quarterly Insight

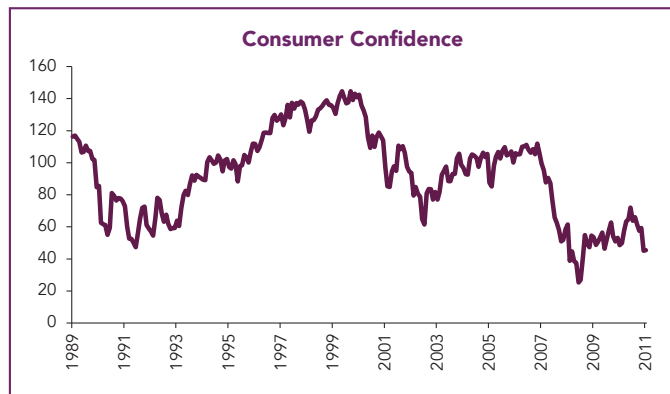
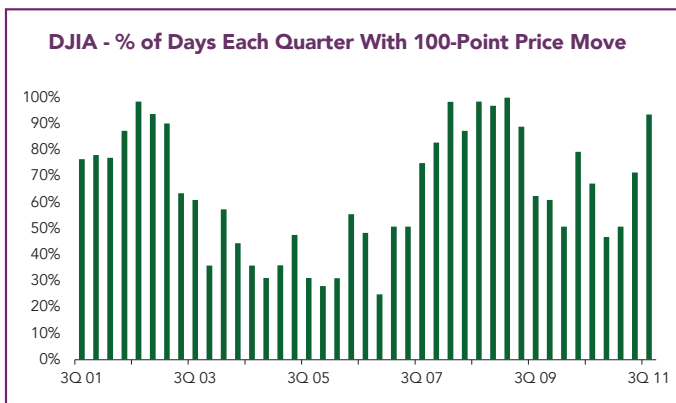
Johnson Private Client Group | Johnson Trust Company | Johnson Institutional Management

Third Quarter 2011

## Market Update

If it feels like the market has grown much more volatile lately, it has. From the middle of July through the end of the quarter, the Dow Jones Industrial Average (DJIA) experienced swings (including intra-day moves) of at least 100 points every single day. Stocks haven't been this volatile day-in and day-out since early 2009. September also marked the fifth straight monthly drop for the S&P 500 Index, a

cumulative decline of 16.3%. Yet, corporate profits continued to advance and interest rates continued to move lower. As a result, equity valuations are now at their lowest level since the market bottomed in 2009, trading around a price/earnings ratio of 11. Not only is this valuation historically cheap, but when compared to bond yields, stocks are at their most attractive point since the Second World War.



So, why have stocks been declining? In a word, fear. Investors worry about the strength of our economic recovery and the possibility of another recession. If earnings fail to meet expectations, then stock valuations may not be so cheap after all. Although growth has clearly moderated recently, the U.S. economy continues to slowly move forward. The economic soft patch that appeared in 2010

has re-emerged this year, driven initially by production dislocations caused by the Japanese earthquake and more recently by a drop in consumer and business confidence. Job growth remains weak as a result. The Federal Reserve has tried repeatedly to address this issue by keeping monetary policy accommodative. Their most recent plan is to launch "Operation Twist" (selling short-term securities to buy long-term securities), which is designed to reduce long-term rates and boost borrowing. We have doubts about the impact of this initiative but expect consumer and business spending will continue to grow, albeit at a slow pace.

## Featuring



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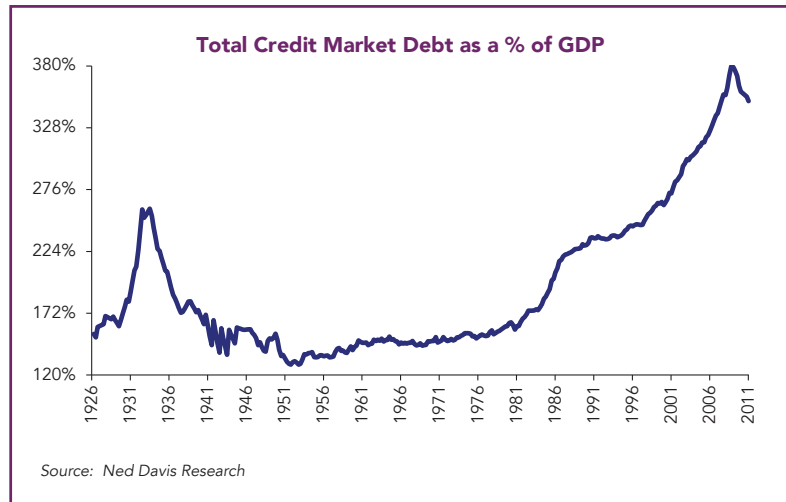
### TOTAL RETURN

Quarter Ending September 30, 2011

S&P 500	-13.9%
Dow Jones Industrial Average	-11.5%
NASDAQ	-12.7%
Russell 2000	-21.9%
MSCI EAFE (International)	-19.0%
Barclays Aggregate Bond Index	3.8%

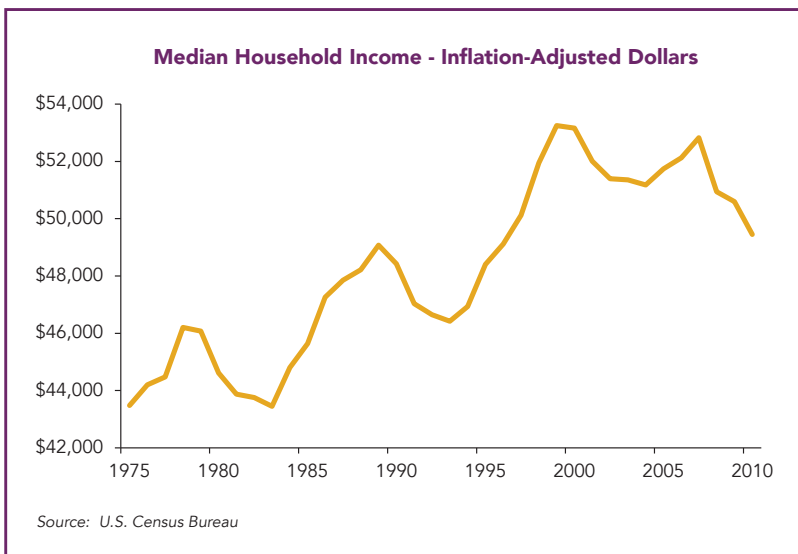
# Market Update (continued from page 1)

Investors are also spooked that a second wave of the financial crisis may emerge, led by defaults in the sovereigns of the Euro region. Greece is very near default, and austerity is being demanded by some and rioted against by others. The European Central Bank has yet to reach a systemic solution to the problems, and until this is resolved, risks will remain elevated. Unfortunately, Washington is contributing to the unease by not effectively dealing with our own fiscal problems. While our elected officials have thus far averted a government shutdown, they have not dealt with the deficit/debt



concerns on a long-term basis. This caused Standard & Poor's to take the drastic action of downgrading U.S. debt from AAA in early August, contributing to investor concerns and driving the stock market lower. This has not negatively affected interest rates yet, but hopefully it serves as a wake-up call.

Regarding debt, as the above chart indicates, the leveraging of America occurred over a period of many decades and has clearly stolen growth from the economy in future years. The decades of the 1980s, 1990s, and 2000s simply grew faster than they otherwise would have as consumers, businesses and the government borrowed and spent. As a result, debt levels reached unsustainable levels relative to the economy and will need to retrench going forward. The private sector has begun to adjust accordingly, as consumers and businesses are borrowing and spending less. While this slows the pace of the economy near term, it also improves balance sheets, which provides some cushion against economic weakness. The public sector has yet to face this reality, but it will ultimately recognize the need to change as well.



Another issue confronting growth is that median incomes for households declined in 2010 (inflation-adjusted) for the third consecutive year. The purchasing power of the typical household has now fallen back to levels last seen in 1996 and is not much higher than twenty years ago. Sluggish wage growth, high unemployment and rising food and energy costs are all contributing to this problem. Combined with shrinking borrowing capacity, consumers are unlikely to increase their spending pace much for the foreseeable future. With consumer spending comprising two-thirds of our economy, it points to a lower-than-average growth scenario in the near term.

Given the realities of economic growth and the wild card of Europe, we believe it is prudent to proceed more cautiously than normal. That does not mean that long-term investors should run away from stocks, though. A fair amount of concern is already reflected in current market valuations for both stocks and bonds, which makes downside risk more limited. In many instances, the dividend yield available on the common stock of high quality companies is higher than the income earned from their long-term bonds. But, as we've suggested for several years, muted economic growth will result in muted investor returns. This makes tactical asset allocation and the inclusion of alternative investments important to long-term results.

# Real Assets' Role in a Diversified Portfolio

We continue to incorporate Real Assets within client portfolios to provide diversification to financial assets as a hedge against inflation and currency devaluation. Real Assets are defined as physical, tangible objects that have economic value. The primary purpose for owning this asset class is to protect against the ravaging effects of inflation and negative real (after inflation) interest rates on wealth, or real purchasing power. Historically, in environments characterized by above-average inflation and negative real interest rates, Real Assets have provided positive real returns. Examples of these assets include energy-related Master Limited Partnerships (MLPs), Commodity Futures, Precious Metals and Real Estate.

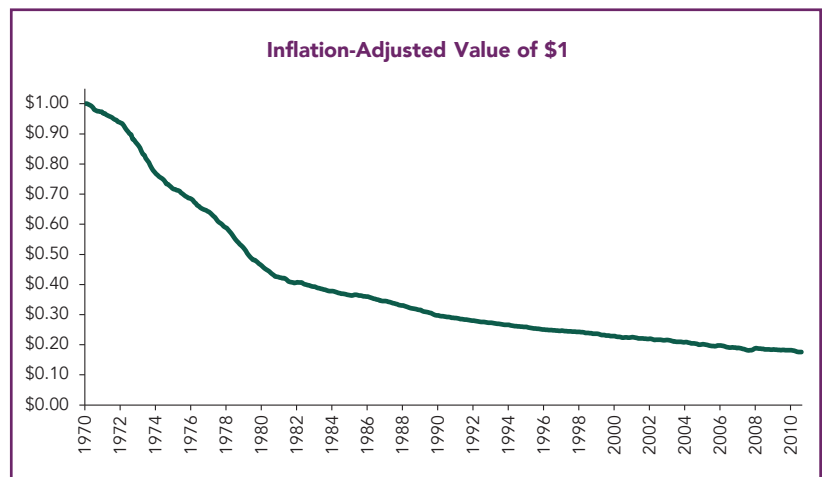
Inflationary shocks experienced in the 1970s and early 1980s are typically what most people think about when they hear the word "inflation." To illustrate the real versus nominal (before inflation) return effects, an analysis of the ten-year period from the beginning of 1972 to the end of 1981 shows that while the nominal cumulative return of a traditional portfolio of 60% stocks and 40% bonds was about 91%, the real cumulative return of that same portfolio was -24%. In other words, nearly one quarter of the real purchasing power of the portfolio was lost over those ten years as nominal returns masked the loss in real wealth. If a constant 4% annual spending rate over that period were assumed, over 50% of the real purchasing power of the initial portfolio would have been lost.

In the current economic environment, the role of Real Assets in a portfolio is taking on greater importance as rising uncertainties related to government fiscal policies and central bank monetary policies pose great risks to the preservation of investors' real wealth. Most economists and market observers define inflation as it relates to the price level captured in a government-determined subjective basket of goods and services known as the Consumer Price Index (CPI). However, due to flaws and several statistical revisions in its calculation methodology, we know that CPI understates true inflation. Going back to 1980, based upon estimates from independent analysts and data from the Bureau of Labor Statistics, this understatement is believed to be at least 3% annually.

This has significant ramifications in terms of investors' goals of preserving or growing their wealth. It points out the need for the inclusion of Real Assets in a traditional portfolio not only when inflation is high, but also in supposedly benign inflation environments. To illustrate this, even using official CPI numbers, the dollar has lost over 80% of its purchasing power since 1971. Since 1990, in a so-called period of low inflation, over 42% of the purchasing power of the dollar has been lost.

From an investment standpoint, rising inflation negatively impacts bond returns, since the interest payments over time lose purchasing power. In relation to stocks, rising inflation leads to higher interest rates resulting in declining valuations.

In order to protect our clients' wealth, we believe energy infrastructure Master Limited Partnerships and Gold are the most attractive Real Assets in the current environment. MLP total returns and distribution growth have historically exceeded the growth in the CPI as regulated pipeline contract prices are set based on the Producer Price Index plus a premium, providing an effective inflation hedge (please refer to our newsletter article from the first quarter of this year that provides more detail on our rationale for investing in MLPs on our website at [www.johnsoninv.com/News.aspx](http://www.johnsoninv.com/News.aspx)). Gold, while a volatile asset, is attractive as it historically has been very effective in preserving wealth in environments characterized by low or negative real interest rates and monetary inflation. Continued "quantitative easing" and interest rate suppression policies by the Federal Reserve, not to mention ongoing devaluation of currencies by central banks at a global level, provide a positive backdrop for Gold prices.



## Congratulations to JIC's New Designation Holders



Sharon G. Tallman  
CFP®, CDFATM

Sharon Tallman is now a Certified Divorce Financial Analyst (CDFATM). These professionals combine their investment expertise and experience with specific training in divorce-related financial issues. A CDFATM is a specially-trained financial professional who evaluates a couple's current financial situation in a neutral manner and develops solutions to complex financial problems. These advisors prepare workable budgets, prioritize financial needs, and assess tax consequences of such areas as property division and support options. The ultimate goal is to reach a financially equitable settlement that meets the personal needs of the parties involved. "Divorce situations are stressful, and the complications surrounding financial matters only heighten the level of anxiety. My goal is to come alongside couples and provide sound counsel to resolve these matters fairly."



David R. Roettker  
CFP®, CRPC®

Dave Roettker recently obtained the Chartered Retirement Planning Counselor (CRPC®) designation. In addition to the key topics of investment strategies/allocation and cash flow considerations, the CRPC® program includes such topics as taxes, long term care, retirement plan distributions and estate planning among the 12 areas of study. "I pursued this training and certification to broaden my knowledge of the many critical components which impact retirement planning. As many of our clients are retired or entering retirement over the next few years, continual education helps ensure that we know the issues to address, what questions to ask and what current strategies exist to help guide them to the best possible decisions."

## Patrick Chong Memorial Scholarship

Johnson Investment Counsel (JIC) established the Patrick Chong Memorial Scholarship in remembrance of Patrick Chong, a Portfolio Manager Assistant at JIC. Patrick died of colon cancer in 2002 at age 31. JIC annually awards two \$2,500 academic scholarships to children of our employees.

This year, we are pleased to honor two outstanding students: Sarah Bishop and Emily Mahler. Sarah is the daughter of Client Support Associate, Lesa Bishop and husband, Jim. She will be attending The Ohio State University in the fall. Emily is the daughter of Receptionist, Jan Mahler and husband, Charlie. She is currently attending Miami University and will be a senior in the fall.

A committee of educators and administrators at the University of Cincinnati judges applicants on the basis of scholastic achievement, extra-curricular activities, community involvement and proven potential in college curriculum.



Sarah Bishop & Emily Mahler

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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- 401(k) Plans
- Foundations
- Endowments
- Johnson Mutual Funds
- Johnson Charitable Gift Fund

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