Capital Market Review

Fourth Quarter, 2011

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Summary
Given all the issues that 2011 brought, from supply chain disruptions due to nuclear catastrophes and flooding, regime change in several Middle Eastern countries, budget and debt crisis, and a U.S. political process that is totally dysfunctional, we think it is amazing how well the capital markets held up. They certainly were volatile.

But, after it was all said and done, the U.S. stock market managed to have a small gain. Specifically, U.S. stocks returned 1.0% for 2011, significantly ahead of developed international (-12.1%) and emerging market (-20.4%) stock returns. U.S. bonds continued their multi-year strong performance returning just under 8%. Real estate had a good year being up nearly 9%, but commodities did not returning -13%.

We have become somewhat more optimistic with respect to stock market returns. Profit margins are high, multiples are below their historic average, and the economy seems to be gaining momentum (but do not expect "robust" economic growth). Of course many things could negatively influence the markets. The most visible appears to be the European crisis, but be aware of escalating issues with Iran.

Johnston Investment Counsel
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Economic Conditional

Although frustrating for investors, it is truly remarkable how well the capital markets, and to a lesser degree, the U.S. economy held up during 2011. Events that were almost unthinkable became reality. A nuclear meltdown in Japan and flooding in Thailand caused worldwide supply-chain disruptions. Political revolution took place in several Arab countries and is continuing today. The U.S. (as well as several European nations recently) had their debt downgraded. The European sovereign debt crisis intensified, causing many to question the viability of the euro (as well as the financial viability of several European countries). The U.S. political process is totally dysfunctional as neither party is willing to compromise and "brinksmanship" is the way the people's business is being conducted. Businesses can make money in a variety of ways but they simply need to know and understand the rules. Solving critical issues at the last possible moment provides business with no certainty about the future and, as a result, businesses will be more hesitant to invest. We should expect more from our political leaders.

And yet, despite all this, the U.S. economy, while weak for a good part of the year, muddled along. The outlook for the U.S. economy has been improving during the past few months. Consumer confidence and spending, manufacturing, the unemployment rate have all been improving. Economic surveys of future activity suggest steady, but not robust future growth. The housing market is even showing small signs of life. Housing starts, permits, and builder sentiment have been gradually improving. Housing inventories are approaching more normal levels (although additional foreclosures are expected), rents continue to increase, and home affordability is at record high levels. While it is way too early to call a turn in real estate, the signs are encouraging.

On the negative side, Europe has not dealt with its debt issues in any comprehensive way. Europe simply has too much debt, is to uncompetitive to grow it's way out of that debt, and does not have their own currency and monetary policy to inflate their way out. We believe the best long-term solution is complete fiscal integration similar to a United States of Europe. A messy divorce resulting in the breakup of the euro-zone would be the worst-case scenario. Of course, the most likely outcome is that Europe will continue to do as little as possible and just muddle through.

The United States is getting a preview of what will be coming our way if we do not get our debt and budget under control. Other threats remain, most notably increasing tensions with Iran over its nuclear program, uncertainty with respect to regime changes in many Middle Eastern countries (i.e. oil), and slowing economic growth (as well as some questionable business loans) in China.

Given the fiscal drag and austerity budgets that will be required out of Europe (and the United States as well), the government sector will certainly not be a significant contributor to economic activity (and may actually be a drag). That leaves consumers and businesses to drive future economic growth. Unfortunately, demographic trends in Europe and in the United States are not particularly favorable as a good portion of the population is now past its peak earning and consuming years. While we do expect the economy to gradually improve, it is unlikely that we will see robust (greater than 4%) economic growth for any sustained period of time.

Stock Market

During 2011, S&P 500 operating earnings rose by approximately 17%, 10-year treasury yields fell from 3.3% to 1.9%, and core inflation, while rising was moderate at a year-over-year rate of 2.2.%. Sounds pretty positive and one would have expected a rise in the stock market. However, investors pulled over $120 billion from equity funds, market volatility spiked several times throughout the year, and political/economic headline risk was particularly high. In the end, the stock market was able to eke out a small gain for 2011.

During the fourth quarter, U.S. stocks rebounded from the third quarters poor results with a return of 12.1%, significantly outperforming the developed international and emerging market returns of 3.3% and 4.1%, respectively. For the year, the U.S. stock market returned 1.0%, ahead of the developed international return of -12.1% and emerging market return of -20.4%.

The fourth quarter small company stock return of 15.5% outperformed the mid-sized stock return of 12.3%, and large company returns of 11.8%. During 2011, large stocks returned 1.5% -- outperforming the mid-stock return of -1.5% and the small stock return of -4.2%

Value stocks outperformed growth stocks during the fourth quarter (13.3% vs. 10.9%). However, during 2011, growth stocks outperformed value stocks (2.2% vs. -0.1%).

During 2011, there was wide dispersion with respect to sector returns. The defensive sectors such as utilities, consumer staples, and healthcare were the best performing (19.9%, 12.7%, and 14.0%, respectively). Financial and economically sensitive sectors such as materials and industrials were the worst performing (-17.1%, -9.8%, and -0.6%, respectively).

Over longer-term periods, corporate profit growth will be the key driver to the stock market's performance. Since the great recession, the recovery and growth of corporate profits has been a consistent story. However, productivity gains, allowing margins to expand, have been responsible for most of the profit growth (as opposed to sales increasing). Since margins are near historic highs, future corporate profit growth will likely be driven by improving sales as opposed to margin expansion (productivity gains). An improving and growing economy could lead to profit growth. However, we do not expect a robust economy and expect corporate profit growth to start moderating.

With that said, we believe current market prices do not fully reflect the improvement in corporate profits that have taken place. Instead, "the market" has been focused on the extraneous noise and headline risks that dominated 2011. We have become more constructive on 2012 stock market returns.

The chart on page 4 provides some interesting data. The top panel calculates expected returns using different multiples, a 7% discount rate, and a range of operating earnings. Using 2012 consensus operating earnings and a 13x multiple (similar to today) would imply a 2012 return of 10.1%. Currently multiples are below their historical average. If, over time, multiples "revert to the mean", that implies a benefit to investors. Alternatively, if we were to capitalize earnings at 7%, expected returns would be higher vis-a-vis the multiple approach. Unfortunately, using reported earnings (instead of operating) does not provide as high of expected returns (but still positive returns).

The point of our analysis is that if earnings growth is in the high single digits or low double digits, stock market returns could be higher than commonly thought. We used the same analysis for large, mid, and small-cap stocks. Regardless of the approach, large-cap stocks are expected to outperform mid- and small-cap stocks.

In the U.S., we will continue to focus on large-company stocks and, given the dramatic declines of 2011, may begin to gradually increase our emerging market allocation.

Bond Market

Interest rates continued to decline during the fourth quarter. The five-year Treasury is currently below 1% and the 10-year Treasury is near 1.9%. Inflation is approximately 2.2%. So, on an inflation-adjusted basis, most Treasury investors are losing money (in terms of purchasing power). While we do not know when it will turn, the Treasury bull market (some would say bubble) will certainly end and Treasury interest rates will start to rise. The Fed has indicated a willingness to keep short-term rates low, but it is the market that will determine intermediate and longer-term Treasury yields.

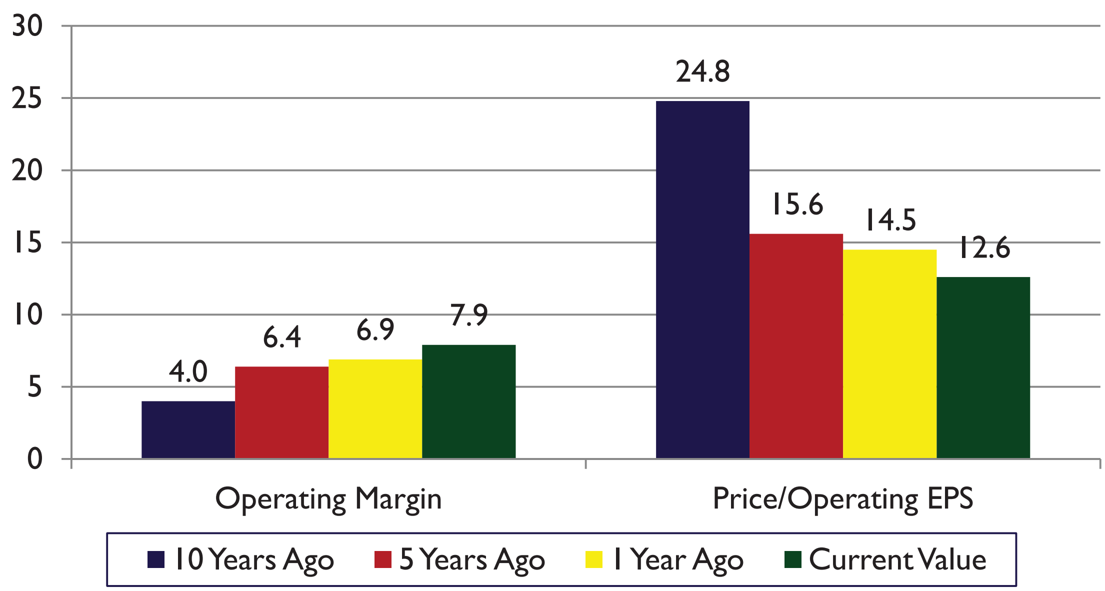
During 2011, the U.S. bond market returned 7.8%, outperforming the developed international bond return of 5.9% and emerging market bond return of 7.3%. Long-term Treasuries were the best performing maturity segment returning 22.5%, followed by the intermediate-term bond return of 5.8%, the short-term bond return of 1.6% and cash return of 0.1%. Government bonds were the best performing sector returning 9.0%, followed by the 8.4% return of the corporate sector and 6.2% return of the mortgage sector.

For the year, municipal bonds returned 10.7%, inflation-protected bonds returned 13.6%, and high-yield bonds returned 5.0%.

During 2012, we expect the economy to continue a slow but steady growth trajectory. In addition, given our belief that the U.S. stock market is undervalued, we will continue to emphasize the riskier bond market sectors such as investment-grade corporate, preferred stocks, and high-yield bonds.

Potential Stock Market Return Scenarios					
		Forecast Returns If:			
	2012 Operating	Earnings Multiple Is:			Discount Rate Is:
	Earnings	13x	15x	17.5x	7%
20% Above Consensus	$127.79	32.1%	52.4%	77.8%	45.2%
10% Above Consensus	$117.14	21.1%	39.7%	63.0	33.1
Consensus Earnings	$106.49	10.1	27.0	48.2	21.0
10% Below Consensus	$95.84	-0.9	14.3	33.4	8.9
20% Below Consensus	$85.19	-11.9	1.6	18.5	-3.2
Large Consensus	$106.49	10.1%	27.0%	48.2%	21.0%
Mid Consensus	$62.86	-7.0	7.3	25.1	2.1
Small Consensus	$27.36	-14.3	-1.1	15.4	-5.8
	Forecast Reported Earnings				
2011	$89.87	-7.1%	7.2%	25.1%	2.1%
2012	$98.88	2.2	17.9	37.6	12.3
2013	$109.29	13.0	30.4	52.1	24.1

S&P 500 Fundamental Characteristics



Stock Returns For Periods Ending December 31, 2011

	Qtr	Ytd	1 Year	3 Year	5 Year		Qtr	1 Year	3 Year
Nationality						**Developed Country**			
U.S. Market	12.1%	1.0%	1.0%	14.9%	0.0%	U.S.	12.1%	1.0%	14.9%
Developed Intl	3.3	-12.1	-12.1	7.7	-4.7	Canada	3.0	-15.5	15.1%
Emerging Market	4.1	-20.4	-20.4	17.3	0.1				
Size						Europe	5.4	-11.1	7.9
Large	11.8	1.5	1.5	14.8	0.0	France	0.7	-20.5	-1.8
Mid	12.3	-1.5	-1.5	20.2	1.4	Germany	2.5	-21.1	0.5
Small	15.5	-4.2	-4.2	15.6	0.2	Italy	-1.6	-27.0	-9.7
Micro	13.1	-9.4	-9.4	20.4	-2.2	United Kingdom	7.0	-7.1	10.3
Approach						Pacific	-0.3	-13.7	7.5
Value	13.3	-0.1	-0.1	11.6	-2.6	Australia	5.5	-4.7	19.3
Core	12.1	1.0	1.0	14.9	0.0	Hong Kong	5.4	-18.6	14.8
Growth	10.9	2.2	2.2	18.1	2.5	Japan	-5.8	-17.8	-0.9
Sector						**Emerging Market**			
Cons Discretionary	12.6	6.1	6.1	24.2	2.0	China	7.9	-20.5	8.9
Cons Staples	10.3	14.0	14.0	14.3	7.6	India	-13.8	-37.6	14.3
Energy	18.2	4.7	4.7	12.8	4.7	Korea	5.9	-12.8	22.8
Finance	10.8	-17.1	-17.1	2.9	-16.9	Czech Republic	-3.2	-12.4	-1.0
Healthcare	10.0	12.7	12.7	11.6	2.8	Hungary	0.3	-33.0	1.3
Industrials	16.5	-0.6	-0.6	15.1	0.5	Poland	-4.8	-31.7	1.8
Technology	8.7	2.4	2.4	22.2	3.8	Russia	5.0	-21.8	22.5
Materials	15.4	-9.8	-9.8	17.9	1.8	Brazil	7.5	-24.9	19.9
Telecomm	7.9	6.3	6.3	11.3	1.4	Chile	7.3	-22.3	26.0
Utilities	8.3	19.9	19.9	12.3	3.7	Mexico	9.4	-13.2	18.7

Stock Fundamentals As Of December 31, 2011

	United States		Developed		Emerging	
	Current	1 Year Ago	Current	1 Year Ago	Current	1 Year Ago
Price/Earnings Current	13.8	15.7	10.9	13.3	9.4	14.1
Price/Forecast Earnings	13.3	14.1	10.4	12.1	10.6	13.5
Price/Book	2.0	2.2	1.2	1.4	1.7	2.2
Price/Cash Flow	8.5	9.5	6.3	6.5	6.5	6.3
Price/Sales	1.2	1.3	0.8	0.9	1.0	1.3
Forecast LT EPS Growth	10.5	10.2	1.6	8.7	16.4	16.6

	Est. P/E Ratio		Est. EPS Growth		2011 Fair Value Returns			2012 Fair Value Returns		
	2011	2012	2011	2012	13x	17.5x	7% DR	13x	17.5x	7% DR
Large	13.0	11.8	15.4	10.1	0.0	34.6	9.8	10.1	48.2	21.0
Mid	17.3	14.0	16.1	23.4	-24.6	1.4	-17.2	-7.0	25.1	2.1
Small	19.8	15.2	23.2	30.7	-34.4	-11.7	-27.9	-14.3	15.4	-5.8

Bond Returns And Characteristics For Periods Ending December 31, 2011

	Qtr	Ytd	1 Year	3 Year	5 Year
Nationality					
U.S. Market	1.1%	7.8%	7.8%	6.8%	6.5%
Developed Intl	-0.2	5.9	5.9	5.5	7.8
Emerging Market	4.7	7.3	7.3	16.1	7.9
Maturity					
Cash	0.0	0.1	0.1	0.1	1.3
Short-Term	0.2	1.6	1.6	2.7	4.0
Intermediate-Term	0.8	5.8	5.8	5.6	5.9
Long-Term	2.6	22.5	22.5	11.2	9.7
Sector					
Corporate	1.7	8.4	8.4	10.9	6.8
Government	0.8	9.0	9.0	4.0	6.6
Mortgage	0.9	6.2	6.2	5.8	6.5
Other					
High Yield	6.5	5.0	5.0	24.1	7.5
Inflation Protected	2.7	13.6	13.6	10.4	8.0
Municipal	2.1	10.7	10.7	8.6	5.2

U.S. Bond Yields	Qtr	Last Qtr	1 Year Ago
Fed Funds	0.07%	0.08%	0.19%
Prime Rate	3.25	3.25	3.25
3 Month Treasury	0.01	0.02	0.12
1 Year Treasury	0.12	0.11	0.29
3 Year Treasury	0.42	0.43	1.07
5 Year Treasury	0.91	0.98	2.06
5 Year TIP	-0.72	-0.56	0.24
10 Year Treasury	1.93	1.99	3.38
30 Year Treasury	2.91	3.03	4.43
Aaa Corporate	3.79	4.1	4.96
Baa Corporate	5.18	5.38	6.05
Barclays Aggregate	2.36	3.23	3.49
Barclays Credit	4.16	4.28	4.55
Barclays Treasury	1.71	1.74	2.02
Barclays Mortgage	5.34	3.34	3.46
Barclays Municipal	2.99	2.99	3.69
Barclays High Yield	7.21	7.87	9.27
Citi Intl Treasury	4.14	2.90	2.27
JPM Emerging	4.89	5.10	5.19

10-Year Sovereign Bond Yields

Developed Mkts	Qtr	Last Qtr	1 Year Ago
United States	1.90%	1.87%	3.52%
Canada	2.06	2.16	3.44
France	3.16	2.60	3.37
Germany	1.92	1.76	3.02
Italy	7.15	5.73	4.54
United Kingdom	2.09	2.40	3.73
Euro Zone	1.97	1.77	2.97
Australia	3.86	4.21	5.67
Hong Kong	1.27	1.29	2.62
Japan	0.98	0.97	1.24
Emerging			
Brazil	11.17	12.00	N/A
China	3.54	4.02	3.82
India	8.72	8.48	8.32
Russia	4.73	4.73	5.78

Spreads Versus 10-Year Treasury

	Qtr	Last Qtr	1 Year Ago
Aaa	1.86	2.11	1.58
Baa	3.25	3.39	2.67
Barclays Aggregate	0.43	1.24	0.11
Barclays Credit	2.23	2.29	1.17
Barclays Treasury	-0.22	-0.25	-1.36
Barclays Mortgage	3.41	1.35	0.08
Barclays Municipal	1.06	1.00	0.31
Barclays High Yield	5.28	5.88	5.89
Citi Intl Treasury	2.21	0.91	-1.11
JPM Emerging	2.96	3.11	1.81
Maturity (10yr-1yr)	1.81	1.88	3.09
Implied Inflation	1.63	1.54	1.82

Commodity, Real Estate, & Currency Returns
For Periods Ending December 31, 2011

	Qtr	Ytd	1 Year	3 Year	5 Year
Commodity					
DJ UBS Commodity	0.3%	-13.3%	-13.3%	6.4%	-2.1%
CRB Commodity Spot	-4.4	-7.4	-7.4	15.2	5.5
CRB Fat & Oils	-10.0	4.1	4.1	22.9	12.7
CRB Foodstuffs	-5.3	-1.1	-1.1	14.0	9.5
CRB Livestock	-9.9	9.0	9.0	22.8	8.7
CRB Metals	-3.1	-16.7	-16.7	27.7	2.4
CRB Raw Industrials	-3.8	-11.5	-11.5	16.1	2.8
CRB Textiles & Fibers	-3.8	-15.2	-15.2	6.3	2.7
Agriculture					
Coffee	-11.8%	2.4%	2.4%	27.6%	13.3%
Corn	-14.6	12.9	12.9	9.8	12.6
Soybean	-9.0	-4.3	-4.3	6.3	12.4
Sugar	-5.3	-2.1	-2.1	23.0	13.7
Wheat	-14.6	0.2	0.2	2.7	7.4
Energy					
Oil	15.1%	10.7%	10.7%	33.9%	9.7%
Unleaded Gas	-5.8	6.7	6.7	26.0	7.0
Metals					
Aluminum	-11.7%	-14.1%	-14.1%	10.4%	-6.4%
Copper	-8.9	-17.4	-17.4	34.5	2.5
Gold	-6.7	18.8	18.8	26.5	21.3
Nickel	-10.5	-24.3	-24.3	22.8	-11.9
Zinc	-7.9	-16.4	-16.4	19.8	-15.3
Real Estate					
MSCI U.S. Reit	15.3%	8.7%	8.7%	21.6%	-1.5%
MSCI World Reit	6.4%	-7.1%	-7.1%	14.0%	-6.2%
Currency		**U.S. Dollar Returns**			
Euro	4.0%	0.2%	0.2%	0.8%	0.0%
Japan	1.4	-6.6	-6.6	-5.2	-7.9
U.K.	1.1	0.0	0.0	-1.7	4.5
Brazil	4.8	8.1	8.1	-8.5	-3.1
China	-0.5	-4.4	-4.4	-2.5	-4.1
India	9.6	15.8	15.8	2.5	3.3
Mexico	5.1	10.8	10.8	0.8	4.8

Summary of Current Economic & Financial Conditions

	Percent Change					
	3 Month % Change	3 Month % Change Annualized	6 Month % Change	6 Month % Change Annualized	1 Year % Change	Data As Of
Gross Domestic Product	0.45	1.81	0.78	1.57	1.46	September
Leading Economic Indicators	1.29	5.26	0.11	0.21	2.84	December
ECRI Weekly Leading Index	1.24	5.06	-4.42	-8.65	-4.39	January
Personal Income	0.59	2.38	0.68	1.37	3.85	November
Retail Sales	1.03	4.19	3.06	6.21	6.27	December
Retail Sales Excluding Motor Vehicles	0.38	1.52	1.86	3.74	5.65	December
Industrial Production	0.73	2.93	2.34	4.73	2.95	December
Number of Unemployed	-5.76	-21.11	-6.61	-12.78	-9.00	December
Announced Layoffs	-63.89	-98.30	0.85	1.71	30.56	December
Output Per Person	0.51	2.08	0.73	1.46	0.69	September
CPI - All Urban Consumers	-0.09	-0.37	1.09	2.19	2.98	December
Personal Consumption Expenditures	0.43	1.75	0.61	1.22	2.02	September
PPI - Finished Goods	-0.16	-0.62	1.00	2.00	4.84	December
CRB Commodity Spot Index	-4.39	-16.45	-12.54	-23.50	-7.40	December
Gold Price	-6.75	-24.38	8.09	16.83	18.82	December
Oil Price	15.14	75.74	2.37	4.79	10.70	December
Housing Starts	1.70	6.99	6.83	14.12	24.90	December
New Single Family Home - Sales	8.62	39.20	2.27	4.60	9.76	November
New Single Family Home - Median Price	-6.20	-22.59	-1.51	-3.00	-2.56	November

	Actual Value / Diffusion Index				
	Current Value	3 Months Ago	6 Months Ago	1 Year Ago	
Phili Fed Survey - General Activity - 6 Months Ahead	49.00	28.80	25.80	47.60	January
Phili Fed Survey - New Orders - 6 Months Ahead	49.70	28.10	31.20	40.50	January
Consumer Sentiment	69.90	59.40	71.50	74.50	December
ISM Purchasing Managers Index	53.90	51.60	55.30	58.48	December
Capacity Utilization - Total	78.12	77.74	76.75	76.76	December
Unemployment Rate	8.50	9.00	9.10	9.40	December
AAII Percent Bullish Investor Sentiment 8 Week Average	39.61	34.07	36.00	52.40	January
AAII BullBear Investor Sentiment Spread	31.96	18.00	6.42	7.75	January
S&P 500 PE Using 10 Year Average Earnings	20.60	19.69	22.09	22.39	December
S&P 500 PE	14.18	13.66	15.51	16.44	December
VIX - Volatility Index	23.40	42.96	16.52	17.75	December
3 Month Treasury Yield	0.01	0.02	0.02	0.12	December
1 Year Treasury Yield	0.12	0.11	0.19	0.29	December
5 Year Treasury Yield	0.91	0.98	1.70	2.06	December
10 Year Treasury Yield	1.93	1.99	3.14	3.38	December
30 Year Treasury Yield	2.91	3.03	4.39	4.43	December
Aaa Corporate Bond Yield	3.79	4.10	5.13	4.96	December
Baa Corporate Bond Yield	5.18	5.38	5.89	6.05	December
Quality Spread (Baa - Aaa Bond Yield)	1.39	1.28	0.76	1.09	December
Term Spread (10 Year - 1 Year Treasury Yield)	1.81	1.88	2.95	3.09	December
Real Yield Spread (10 Yr TBond- 1 Yr Expected Infl)	-1.27	-1.31	0.44	0.68	December