Capital Market Review

Third Quarter, 2013

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Summary

No major changes to the U.S. economy. Gradual and slow improvement. Business is extremely profitable. On average, consumer is treading water (stagnant wage growth). Fed decided not to reduce its bond purchases in an attempt to maintain low interest rates (surprised the bond/stock markets with decision). Given new budget/debt ceiling debate in January/February as well as new FED chairwoman, we do not see any tapering until late in the first quarter of 2014 at the earliest. Allows bond investors to consider re-positioning portfolios for higher interest rates.

Biggest economic risk, to us, is the inability of the government to develop a long-term policy. Flirting with debt ceilings limits and closing the government is dangerous as there is a risk they may go too far.

During the third quarter, stock markets, worldwide, rallied. Bond returns were positive due to the delay in tapering and uncertainty during the government shutdown. However, interest rates, across the yield curve are substantially higher than one year ago and will likely continue to increase.

Johnston Investment Counsel
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Economic Conditions

For over a year, the Federal Reserve has made significant monthly purchases of long-term U.S. Treasury and mortgage-backed bonds. The goal of this program, known as quantitative easing, is to keep long-term interest rates low, thereby encouraging longer-term investments (business capital expenditures and residential housing purchases). However, by doing this, the FED is distorting the normal interest rate setting process.

As U.S. economic conditions improve, many thought the FED would begin to reduce (not stop) its bond purchases at its September meeting. As this possibility became better known, the bond market sold off – raising interest rates across the yield curve.

Clearly surprising the bond market at the September meeting, the FED decided not to reduce its purchases and the bond market rallied. The FED apparently felt that the labor market was still too weak, higher interest rates would impede the housing sector recovery, and a concern about the impending budget and debt ceiling challenges and the effect it would have on the economy.

In early October, the president announced Janet Yellen as his nominee to chair the Federal Reserve (for the departing Ben Bernanke). Ms. Yellen is widely regarded as a strong advocate of the current FED policy. Under Ms. Yellen's leadership, most believe that current policy will be maintained for at least a few more months. We agree, partially due to her past policy support, but also as a result of the unknown (as of now) economic impact associated with the government shutdown. In addition, we expect her to remain cautious as there is uncertainty surrounding the next budget/debt ceiling debate that will occur in only a few months (January/February of next year). We believe the most likely scenario is that any tapering has been pushed back to February, 2014 at the earliest.

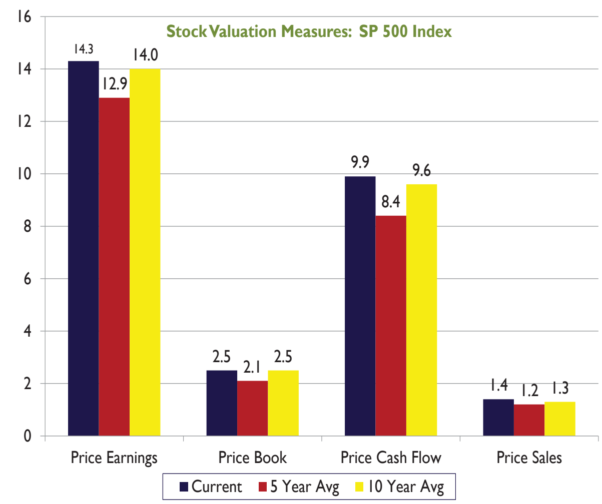
When the FED begins to reduce its buying and/or actually increase short-term interest rates, investors will likely see a significant and quick rise in interest rates. Depending on the magnitude of the interest rate rise, that will likely slow the economy. The key question is whether the bond market will "overshoot" on the interest rate increase and raise the chances of the economy slowing more than desired.

An additional positive surprise during the third quarter is that Europe appears to be moving from recession to a slow recovery. It is still too early to tell if the recovery is sustainable. European stock markets have responded positively.

Most major sectors of the economy (consumer, business, labor, etc.) appear to be slowly but steadily improving. The business sector is particularly profitable. Unemployment has been declining, but wage growth is stagnant. Housing stalled for a month or two when interest rates rose, but appears to have stabilized. We believe housing will continue to gradually improve. All in all, we see no major economic shocks during the next several months. Potential issues could be the rise in interest rates associated with a Fed tapering and the uncertainty associated with budget and debt ceiling debates and associated policy.

Stock Market

Stock markets, worldwide, had a strong third-quarter lead by the developed international stock return of 11.6%. U. S. stocks returned 6.3%, while emerging market stocks returned 5.0%. Year-to-date, US stocks are up over 21%, developed international stocks up 16.1%,



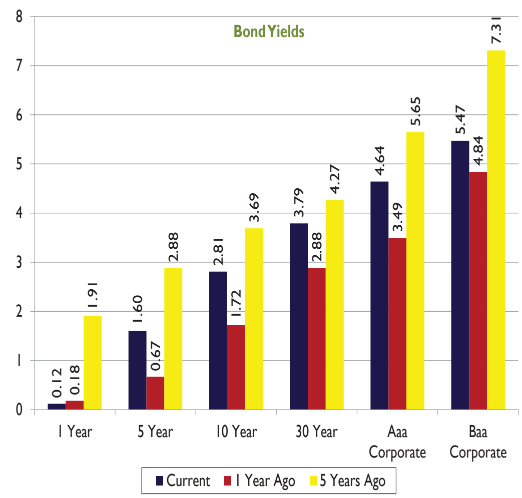
tions and utilities have substantially lagged the market return.

Corporate fundamentals, including record high profits and historically low leverage, point to a healthy corporate landscape. While equity valuations are near long-term averages, that does not mean an impending correction is near. In short, bull markets do not stop at the average. Nevertheless, we believe the "easy" money has been made and future equity return expectations should be moderated. We believe that large-company stocks offer more attractive future return potential (over the next 5 years) vis-à-vis mid and small company stocks.

Bond Market

Intermediate- and longer-term treasury bond yields have risen substantially compared to last quarter and one year ago. In most maturity segments, bond yields are 1% or sell higher than a year ago. In some respects, the bond market is starting to do the Fed's work for it. Nevertheless, when the Fed decides to make a policy change, it is likely bond yields will continue to rise (negatively affecting bond returns).

The Fed's decision not to taper its bond purchases creates an opportunity for bond investors to make adjustments to their bond portfolios. Generally speaking, bonds do not perform well in rising interest rate environ-



ments. However, certain bond segments may perform better than treasuries. Generally speaking, it may be appropriate for bond investors to consider lowering the average maturity of their portfolio, as well as consider higher-yielding bond sectors such as corporate and/or mortgage-backed bonds.

Stock Returns For Periods Ending September 30, 2013

	Qtr	Ytd	1 Year	3 Year	5 Year
Nationality					
U.S. Market	6.3	21.3	21.6	16.8	10.6
Developed Intl	11.6	16.1	23.8	8.5	6.4
Emerging Market	5.0	-6.4	-1.5	-2.8	4.6
Size					
Large	6.0	20.8	20.9	16.6	10.5
Mid	7.7	24.3	27.9	17.5	13.0
Small	10.2	27.7	30.1	18.3	11.2
Micro	12.2	39.0	36.1	22.8	16.1
Approach					
Value	4.2	20.7	22.7	16.3	8.9
Core	6.3	21.3	21.6	16.8	10.6
Growth	8.5	21.8	20.3	17.2	12.2
Sector					
Cons Discretionary	7.8	29.1	31.8	24.1	18.8
Cons Staples	0.8	16.1	14.0	15.9	10.9
Energy	5.2	15.4	12.3	15.4	6.6
Finance	2.9	22.9	30.2	13.6	1.7
Healthcare	6.8	28.5	28.5	20.9	13.1
Industrials	8.9	23.9	28.5	16.7	10.6
Technology	6.6	13.4	6.9	13.7	12.0
Materials	10.3	13.5	16.6	11.9	8.2
Telecomm	-4.4	5.7	-0.7	12.6	11.2
Utilities	0.2	10.1	7.0	10.6	7.1

	Qtr	1 Year	3 Year
Developed Country			
U.S.	6.3	21.6	16.8
Canada	8.2	-0.1	0.1
Europe	13.6	24.2	8.7
France	15.3	29.0	3.4
Germany	12.7	22.8	7.5
Italy	19.0	15.4	-6.6
United Kingdom	11.0	12.7	5.7
Pacific	8.0	23.3	8.3
Australia	10.4	7.4	7.9
Hong Kong	8.1	10.5	3.5
Japan	6.0	29.4	6.0
Emerging Market			
China	11.5	9.2	-2.7
India	-5.7	-13.7	-12.1
Korea	14.9	3.3	5.2
Czech Republic	13.3	-17.5	-11.1
Hungary	-4.9	-4.4	-11.2
Poland	14.1	6.3	-3.8
Russia	13.1	-1.0	-1.1
Brazil	7.7	-11.4	-13.6
Mexico	-2.0	-3.4	5.5

Stock Fundamentals As Of September 30, 2013

	United States		Developed		Emerging	
	Current	1 Year Ago	Current	1 Year Ago	Current	1 Year Ago
Price/Earnings Current	17.3	15.2	15.2	10.9	11.2	9.5
Price/Forecast Earnings	15.8	14.4	14.1	11.5	11.0	10.5
Price/Book	2.4	2.1	1.5	1.3	1.5	1.5
Price/Cash Flow	10.5	9.1	8.6	6.3	6.9	6.6
Price/Sales	1.5	1.2	0.9	0.7	1.1	1.0
Forecast LT EPS Growth	9.5	10.7	7.9	9.2	12.1	11.7

	Est. P/E Ratio		Est. EPS Growth		Fair Value Returns			Fair Value Returns		
	2013	2014	2013	2014	13x	17.5x	7% DR	13x	17.5x	7% DR
Large	15.7	13.9	11.1	13.1	-17.4	11.2	-9.2	-6.5	25.8	2.7
Mid	20.2	16.9	13.5	19.2	-35.6	-13.3	-29.2	-23.3	3.3	-15.7
Small	22.3	17.3	25.6	29.3	-41.8	-21.7	-36.1	-24.7	1.3	-17.3

Bond Returns And Characteristics For Periods Ending September 30, 2013

	Returns				
	Qtr	Ytd	1 Year	3 Year	5 Year
Nationality					
U.S. Market	0.6	-1.9	-1.7	2.9	5.4
Developed Intl	4.2	-3.7	-6.3	0.5	4.6
Emerging Market	1.2	-6.7	-4.1	4.9	9.8
Maturity					
Cash	0.0	0.0	0.1	0.1	0.1
Short-Term	0.4	0.5	0.6	1.1	2.5
Intermediate-Term	0.6	-0.8	-0.5	2.4	5.0
Long-Term	-0.8	-8.7	-8.3	4.7	9.1
Sector					
Corporate	0.7	-2.9	-1.9	4.1	8.5
Government	0.1	-1.9	-2.0	2.1	4.0
Mortgage	1.0	-1.0	-1.2	2.6	4.7
Other					
High Yield	2.3	3.7	7.1	9.2	13.5
Inflation Protected	0.7	-6.7	-6.1	4.0	5.3
Municipal	-0.2	-2.9	-2.2	3.2	6.0

U.S. Bond Yields	Qtr	Last Qtr	1 Year Ago
Fed Funds	0.08	0.09	0.14
Prime Rate	3.25	3.25	3.25
3 Month Treasury	0.02	0.05	0.11
1 Year Treasury	0.12	0.14	0.18
3 Year Treasury	0.78	0.58	0.34
5 Year Treasury	1.60	1.20	0.67
5 Year TIP	-0.17	-0.59	-1.47
10 Year Treasury	2.81	2.30	1.72
30 Year Treasury	3.79	3.40	2.88
Aaa Corporate	4.64	4.27	3.49
Baa Corporate	5.47	5.19	4.84
Barclays Aggregate	2.40	2.45	2.40
Barclays Credit	3.54	3.57	3.57
Barclays Treasury	1.46	1.52	1.68
Barclays Mortgage	1.11	1.34	2.50
Barclays Municipal	2.74	2.81	2.94
Barclays High Yield	6.38	6.63	6.94
Citi Intl Treasury	1.59	1.77	3.03
JPM Emerging	4.65	4.60	4.38

10-Year Sovereign Bond Yields

Developed Mkts	Qtr	Last Qtr	1 Year Ago
United States	2.71	2.30	1.62
Canada	2.69	2.25	1.75
France	2.51	2.11	2.21
Germany	2.00	1.56	1.45
Italy	4.46	4.26	5.29
United Kingdom	2.83	2.17	1.75
Euro Zone	2.00	1.56	1.45
Australia	4.05	3.42	2.98
Hong Kong	2.33	1.69	0.78
Japan	0.71	0.82	0.78
Emerging			
Brazil	11.52	11.12	9.57
China	3.98	3.25	3.16
India	8.37	7.28	8.17
Russia	7.66	7.66	8.17

Spreads Versus 10-Year Treasury

	Qtr	Last Qtr	1 Year Ago
Aaa	1.83	1.97	1.77
Baa	2.66	2.89	3.12
Barclays Aggregate	-0.41	0.15	0.68
Barclays Credit	0.73	1.27	1.85
Barclays Treasury	-1.35	-0.78	-0.04
Barclays Mortgage	-1.70	-0.96	0.78
Barclays Municipal	-0.07	0.51	1.22
Barclays High Yield	3.57	4.33	5.22
Citi Intl Treasury	-1.22	-0.53	1.31
JPM Emerging	1.84	2.30	2.66
Maturity (10yr-1yr)	2.69	2.16	1.54
Implied Inflation	2.14	2.04	2.45

Commodity, Real Estate, & Currency Returns
For Periods Ending Setember 30, 2013

	Qtr	Ytd	1 Year	3 Year	5 Year
Commodity					
DJ UBS Commodity	2.1	-8.6	-14.3	-3.2	-5.3
CRB Commodity Spot	-0.2	-3.4	-6.1	-1.4	2.5
CRB Fat & Oils	0.8	0.0	-9.9	-0.9	2.0
CRB Foodstuffs	-0.4	-5.2	-11.2	-2.5	1.4
CRB Livestock	-1.8	1.5	3.9	5.5	5.2
CRB Metals	7.2	-3.7	-2.3	0.3	5.6
CRB Raw Industrials	0.0	-2.2	-2.3	-0.6	3.3
CRB Textiles & Fibers	-0.5	0.3	0.7	-4.4	2.2
Agriculture					
Coffee	-4.4	-13.9	-26.1	-15.8	-1.1
Corn	-24.2	-23.1	-23.4	9.0	1.1
Soybean	-8.6	-3.5	-3.5	11.4	5.0
Sugar	10.1	-4.4	-16.2	-15.1	-1.2
Wheat	-7.8	-18.6	-18.4	5.2	-1.9
Energy					
Oil	11.0	20.5	12.4	12.2	0.5
Unleaded Gas	-2.1	4.9	-9.5	8.1	-1.0
Metals					
Aluminum	-2.9	-15.6	-14.7	-6.7	-6.9
Copper	2.3	-10.1	-11.5	-2.5	0.5
Gold	0.5	-20.1	-22.7	2.0	10.2
Nickel	-3.4	-20.9	-20.2	-15.3	-4.9
Zinc	0.4	-9.5	-8.1	-5.0	1.1
Real Estate					
MSCI U.S. Reit	-3.0	3.2	5.7	11.2	5.6
MSCI World Reit	2.5	3.7	9.1	9.9	6.7
Currency			**U.S. Dollar Returns**		
Euro	-1.2	-1.8	-3.7	-0.7	1.4
Japan	2.1	18.5	27.0	5.6	-1.4
U.K.	-2.5	1.7	1.6	-0.6	2.5
Brazil	4.2	9.0	11.7	9.6	4.7
China	-0.2	-1.8	-3.2	-3.2	-2.2
India	9.0	16.5	17.1	11.5	6.9
Mexico	0.7	1.4	1.0	0.7	4.1

Current Economic & Financial Conditions

	Percent Change					
	3 Month	3 Month Annualized	6 Month	6 Month Annualized	1 Year	Data As Of
Gross Domestic Product	0.6	2.5	0.9	1.8	1.6	June/2013
Leading Economic Indicators	#####	-100.0	-1,000.0	-100.0	-1,000.0	September/2013
ECRI Weekly Leading Index	1.6	6.4	2.0	4.0	4.2	September/2013
Commercial and Industrial Loans At All Commercial Banks	1.2	4.8	3.0	6.0	8.2	September/2013
Retail Sales	1.4	5.9	1.7	3.5	4.8	August/2013
Retail Sales (Excluding Food Service)	1.4	5.9	1.7	3.5	4.8	August/2013
Real Disposable Personal Income	0.4	1.5	1.2	2.4	1.6	August/2013
Industrial Production	0.5	2.0	0.5	1.1	2.7	August/2013
ISM Manufacturing: Purchasing Managers Index	10.4	48.6	9.6	20.0	8.9	September/2013
4-Week Moving Average of Initial Claims	-11.8	-39.4	-14.1	-26.2	-18.4	September/2013
Hires: Total Private	-0.3	-1.0	1.4	2.8	2.7	August/2013
Job Openings: Total Private	1.2	4.8	1.2	2.4	9.2	August/2013
Consumer Price Index	0.7	3.0	0.3	0.7	1.5	August/2013
Consumer Price Index Less Food and Energy	0.4	1.8	0.8	1.5	1.8	August/2013
New One-Family Houses Sold	-1.9	-7.3	-5.4	-10.5	12.6	August/2013
Median Sales Price of Homes Sold	2.3	9.6	5.0	10.3	10.8	June/2013
S&P 500 Earnings	1.4	5.6	1.4	2.8	-0.9	March/2013
CRB Commodity Spot Index	-0.2	-0.6	-2.6	-5.0	-6.1	September/2013
Spot Oil Price (West Texas Intermediate)	13.6	66.7	10.5	22.1	19.0	July/2013
Gold Price	11.3	53.4	N/A	N/A	-25.3	September/2013

	Actual Value / Diffusion Index				
	Current Value	3 Months Ago	6 Months Ago	1 Year Ago	Data As Of
Phili Fed: General Activity - vs. Prior Month (Diffusion)	22.3	12.5	2.0	1.4	September/2013
Phili Fed: General Activity - 6 Months Ahead (Diffusion)	58.2	33.7	32.5	40.9	September/2013
Chicago Fed: National Activity Index	0.1	-0.1	0.6	-1.0	August/2013
St. Louis Financial Stress Index	-0.6	-0.3	-0.9	-0.6	September/2013
Loan Officer Net % Tighter Criteria Consumer Loans	-3.6	-7.4	-2.0	-10.9	September/2013
Loan Officer Net % Willingness to Make Consumer Loans	13.0	22.2	11.1	21.7	September/2013
Consumer Sentiment	77.5	84.1	78.6	78.3	September/2013
Manpower Employment Outlook (Net % Hiring)	11.0	12.0	11.0	10.0	August/2013
Unemployment Rate	7.6	7.9	7.9	8.3	September/2013
University Of Michigan Inflation Expectations	3.3	3.0	3.2	3.3	September/2013
AAII Survey: Stock Allocation	64.5	62.1	59.5	60.1	September/2013
AAII Bull/Bear Investor Sentiment Spread	5.4	-4.9	9.7	-0.4	September/2013
AAII Percent Bullish 8-Week Average	37.3	36.8	38.6	36.6	September/2013
CBOE Volatility Index	16.6	16.9	12.7	15.7	September/2013
3 Month Treasury	N/A	0.1	0.1	0.1	September/2013
1 Year Treasury	0.1	0.1	0.2	0.2	September/2013
5 Year Treasury	1.6	1.2	0.8	0.7	September/2013
10 Year Treasury	2.8	2.3	2.0	1.7	September/2013
30 Year Treasury	3.8	3.4	3.2	2.9	September/2013
5 Year TIP	-0.2	-0.6	-1.4	-1.5	September/2013
10 year TIP	0.7	0.3	-0.6	-0.7	September/2013
30 Year TIP	1.5	1.2	0.6	0.4	September/2013
Bond Buyer 20-Bond Municipal Bond Index	4.8	4.3	4.0	3.7	September/2013
ML BBB	4.0	4.1	3.4	3.5	September/2013
ML High Yield	6.5	6.8	5.9	6.6	September/2013
ML AAA-A Emerging Market	3.0	3.2	2.4	2.5	September/2013

Leading economic indicator index is not available due to the government shutdown.

A diffusion index is the difference between the percent of respondents expecting an increase less those expecting a decrease.