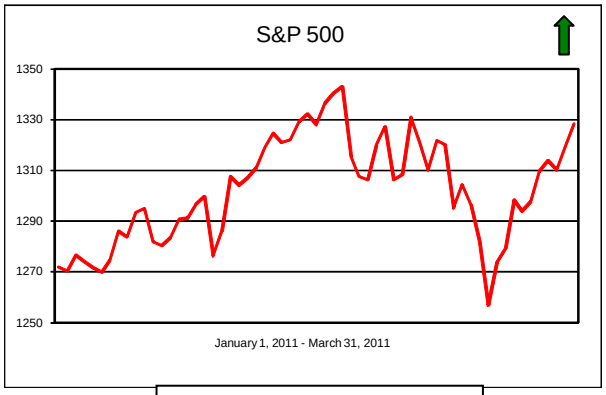
Wallington ASSET MANAGEMENT
INDEPENDENT INVESTMENT COUNSEL

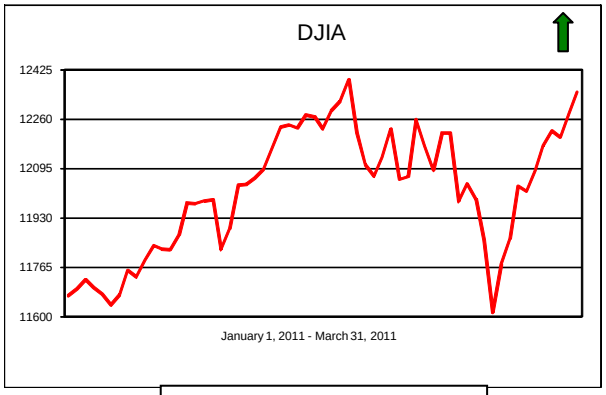
QUARTERLY REVIEW *89th Edition* *2011: First Quarter*

CAPITAL MARKETS SCOREBOARD

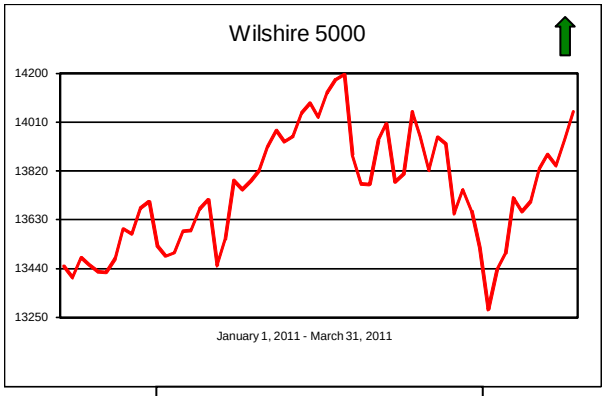
January 1, 2011 – March 31, 2011



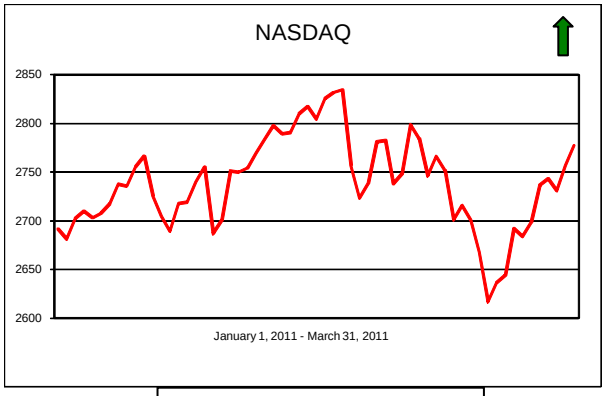
1st Qtr 5.92% YTD 5.92%



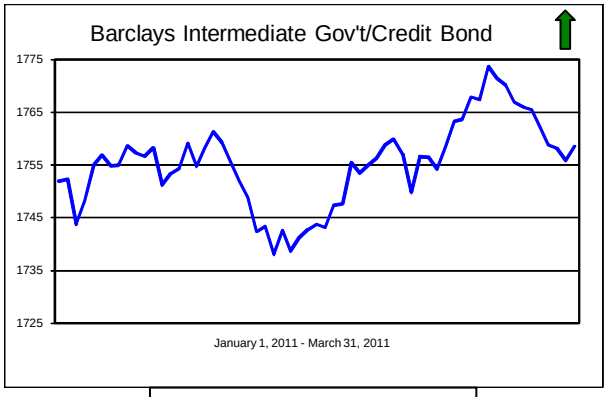
1st Qtr 6.41% YTD 6.41%



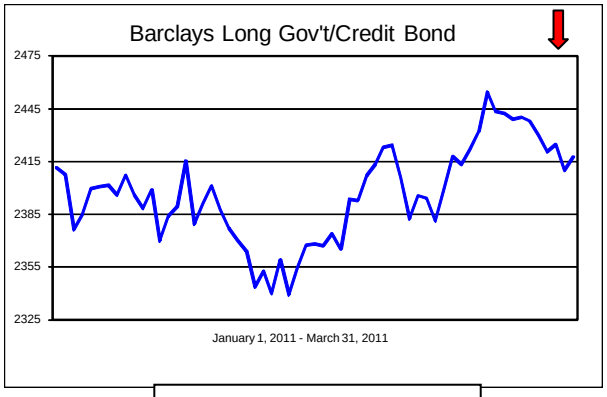
1st Qtr 5.62% YTD 5.62%



1st Qtr 4.83% YTD 4.83%



1st Qtr 0.34% YTD 0.34%



1st Qtr -0.02% YTD -0.02%

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EQUITIES

Equity Market Performance

The Standard & Poor's 500 Index (S&P 500) gained as much as 6.8% in the first quarter of 2011 before the combination of geopolitical problems in the Middle East and North Africa (MENA) inspired a 12-day bout of 25 to 35 point swings for the S&P 500. Japan's post-tsunami nuclear disaster ultimately eliminated the trading range and drove the index down 6.4% relative to its intra-quarter high of 1,338. The negative sentiment began to fade as quarter-end approached, though, allowing the S&P 500 and the other major indices to post positive returns for the quarter. The accompanying chart breaks down the sector returns that make up the S&P 500's price only (excluding dividends) gain of 5.42%. This was the third straight quarter that the index generated a positive return and it bested any first quarter rise since 1998, including the 4.87% gain in the first quarter of 2010.

S&P 500 by GICS Sector	Price Return (%)	
	1Q11	**YTD**
Energy	16.3	16.3
Industrials	8.2	8.2
Health Care	5.0	5.0
Consumer Discretionary	4.4	4.4
Materials	4.1	4.1
Telecommunications	3.5	3.5
Information Technology	3.3	3.3
Financials	2.8	2.8
Consumer Staples	1.7	1.7
Utilities	1.6	1.6
S&P 500 Index	**5.4**	**5.4**

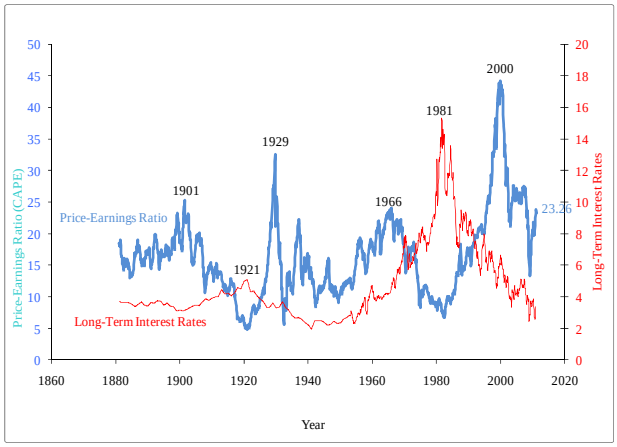
Source: Bespoke Investment Group

Earnings Growth

After tallying 495 quarterly earnings reports for the fourth quarter of 2010, 76% of the companies posted *positive* earnings per share (EPS) growth on a year-over-year basis while 72% managed to record *better-than-expected* (above analysts) EPS growth. Alcoa's earnings announcement on April 11th once again acts as the unofficial start of earnings season for the first quarter of 2011. The S&P 500 is expected to report earnings per index share of about $21.81 for the quarter, which is slightly lower than the previous quarter, but 12% higher on a year-over-year basis. Since revenues are expected to grow at a slower rate than bottom line earnings, it is expected that corporate profit margins will have expanded again during the first quarter of the year. As the accompanying chart reflects, the highest growth on a per sector basis is expected in the Energy Sector and the Materials Sector, largely due to the increases recently experienced in commodity prices. These increases are expected to negatively impact the earnings growth posted by some other sectors, however, as input price increases may not be able to be fully passed on in the form of higher prices.

Market Valuation

Wallington's first quarter 2010 newsletter discussed the market's valuation level, as represented by the price to earnings (P/E) ratio of the S&P 500. Since an entire year has passed, revisiting that discussion seems appropriate. In early 2010, consensus earnings estimates for the S&P 500 in 2010 and 2011 were $78.16 and $93, respectively. Sales were expected to grow 5.5% in 2010 and 7% in 2011, leading to peak, or near-peak, margins last achieved in 2007. At the time, William Hester with Hussman Funds was one of many strategists who argued that the S&P 500 was somewhat richly valued at 15 times expected earnings for 2010. Hester's research led him to conclude that the approximate long-term P/E ratio based on expected earnings over the next twelve months should be 12. Also, Professor Robert Shiller's Cyclically Adjusted P/E (CAPE)

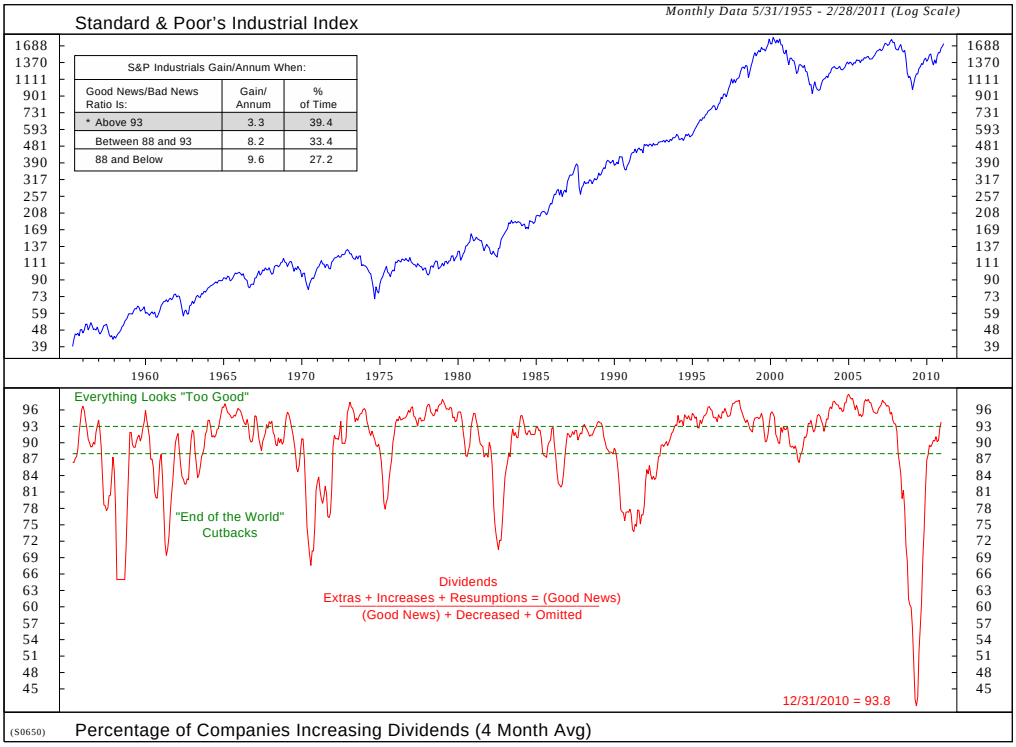


http://www.econ.yale.edu/~shiller/data/ie_data.xl

ratio was at 20, higher than the long-term average of 16. Professor Jeremy Siegel of *Stocks for the Long Run* fame, however, indicated that an adjustment to the long-term average multiple of 12 had to be made for the market when earnings were rebounding after a recession. According to Siegel, the average post-recession multiple has been 18.5 times expected earnings. With the market multiple at 15 in early 2010, Siegel felt that the market was undervalued. Moving forward, at the end of the first quarter of 2011, the price for the S&P 500 index was 1,325.8 or 14.3 times earnings expected in 2011 – that is, the market appears more attractively valued today than it did one year ago, despite the almost 20% price gain since the beginning of 2010. However, it is still "rich" when compared to the long-term average of 12. Shiller's CAPE ratio indicates that the market is even more overvalued on a year-over-year basis, as the reading has risen from 20 to 23.3 (see chart on previous page). The current forward P/E ratio is still less than Siegel's 18.5 average, though, which continues to lend opposition to the thought that the market is really overvalued.

Corporate Cash Balances Revisited

Throughout 2010, we noted the high and rising levels of cash held by corporations, likely as a result of fresh memories from the credit crisis. This quarter, though, Bloomberg reported that cash and short-term investments held by the companies in the S&P 500 declined by $60 billion to $2.4 trillion from $2.46 trillion. It was the first decline since mid-2009. Corporations are choosing to spend their respective cash balances on share repurchases, new plant and equipment, acquisitions and dividends, all of which have provided an upside catalyst to equity prices.



With respect to dividends, the ratio of dividend increases, resumptions and one-time specials ("Good News" as Ned Davis Research labels it) versus dividend decreases or omissions has rebounded sharply from the dark days of 2008-2009. Note that the increase has occurred even though a host of major banks, including Wells Fargo and JP Morgan (but not Bank of America/Merrill Lynch), just recently received permission from the Federal Reserve to materially raise their dividend payouts. Clearly, bank solvency ratios have improved dramatically in two years. In fact, JP Morgan has enough liquid assets that it agreed to fund, by itself, a $20 billion bridge loan for AT&T in their $39 billion takeover of T-Mobile.

Financial Consequences of Japan's Disasters

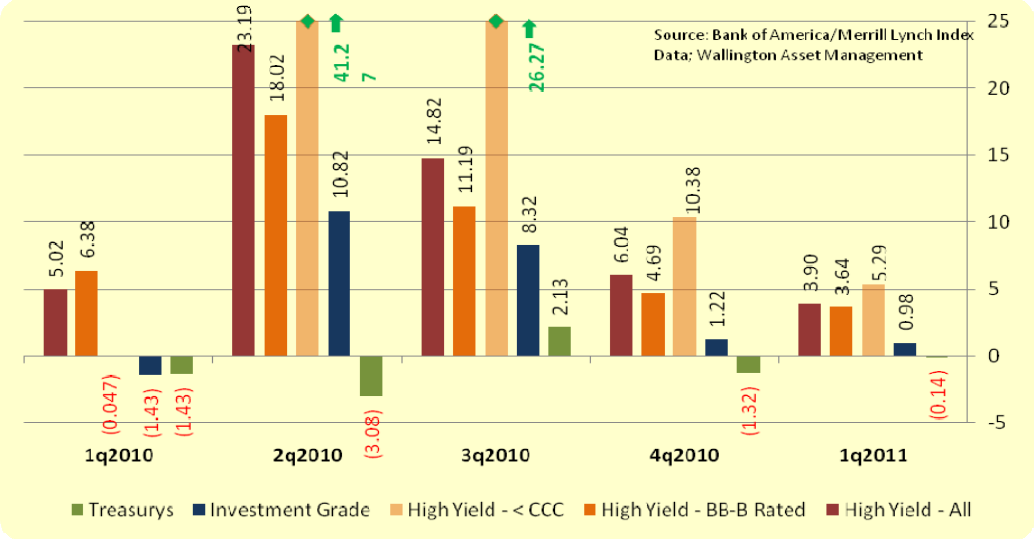
The business consequences from the earthquake, tsunami and resulting nuclear power plant disaster pale in comparison to the tragedy of lost life and infrastructure destruction in Japan. They need to be considered, though, since the impact will definitely be felt in the global economy in both the short-term and long-run. For instance, due to the interconnected nature of worldwide industrial production, interruptions to supply chains are obviously going to be a problem. Indeed, Japanese automakers suspended or reduced production, limiting availability of dealer inventory as well as certain maintenance and repair parts. Also, worldwide consumer electronics production will suffer because 90% of the adhesive used in LCD panels was produced by Sony and Hitachi. Insurance companies will also feel the pressure, but not from the earthquake directly (earthquake insurance was far too expensive). Instead, insurers will likely end up paying business interruption and lost profit claims. Finally, some highly specialized industrial parts produced only in Japan will naturally grind manufacturing to a halt in the near-term for those end products. Longer-term, there is some hope the disasters will provide at least some type of silver lining for Japan. Post-disaster, Japan will need to rebuild and replace a significant portion of the infrastructure, property and equipment lost since March 11th. These efforts should spur demand for a variety of products from numerous industries,

including cement and aggregates, construction equipment and industrial production equipment, as well as offer employment opportunities to those involved. Just how much of an impact the disasters will have is largely unknown, though, and will only be known as time passes.

ECONOMICS AND FIXED INCOME

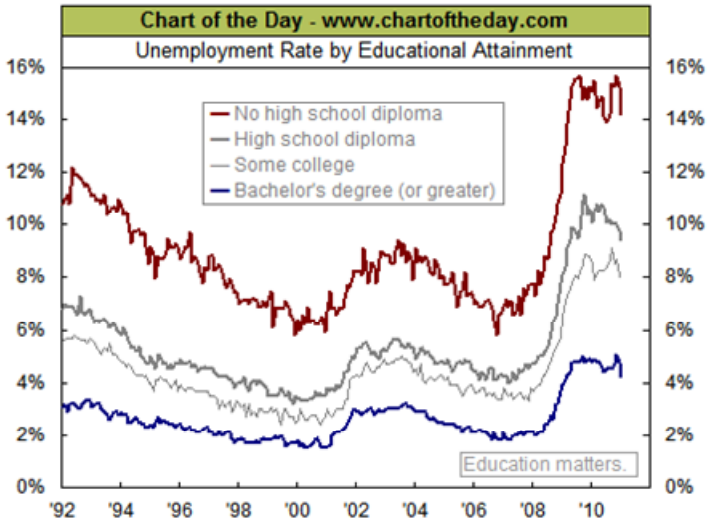
Fixed Income Market Performance

In the first quarter of 2011, the various classes within the fixed income market showcased the "risk on/risk off" nature of investor sentiment, as well as the first-order effect of the Federal Reserve Board's (Fed) "accommodative" monetary policy. Treasury bonds, for instance, performed better than corporate bonds each time a major geopolitical event roiled the world (risk off). Once those concerns were placated, though, market participants directed their attention back to securities with better return prospects (risk on). This dynamic helps explain why the benchmark 10-Year U.S. Treasury bond yielded between 3.22% and 3.75% within a 45-day period during the quarter, representing fairly significant intra-quarter price changes, especially for Treasury instruments.



The Fed's easy money, "low for long" monetary policy allowed investment grade (IG) companies, those rated between AAA and BBB-, to borrow funds at historically low rates and it allowed high-yield (HY) companies, corporations with ratings of BB+ or lower (aka "junk" ratings), to borrow new money and/or refinance debt issued near the credit bubble peak at similar rates. In fact, new debt issuance by investment grade corporate borrowers equaled $279 billion in the first quarter, which was the third-highest quarterly amount ever and an increase of 19% year-over-year. Perhaps more indicative of investors clamoring for yield, high-yield issuers placed nearly $114 billion of new debt in the quarter, which is the highest single quarterly amount on record according to Dealogic. If investors were not as receptive to high-yield debt issuance, many of the companies below investment grade would have faced punitively high refinancing rates or possibly even bankruptcy. Easy money has been an obvious boon to corporations.

The Value of Education

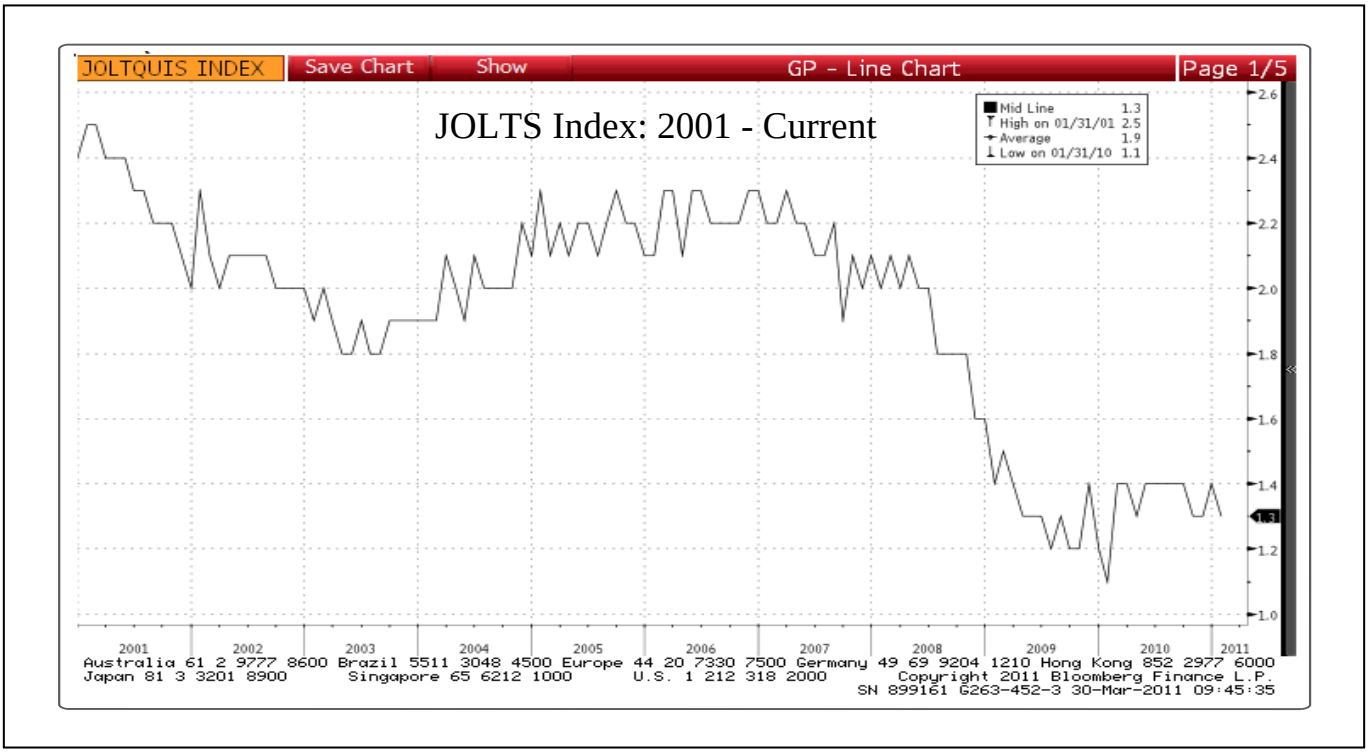


Although a number of multi-billionaires never earned a college degree[1], the accompanying chart from chartoftheday.com, clearly illustrates the value of education using just a single metric. Based on round numbers, those who lack a high school diploma currently face an unemployment rate 3.5 times as large as those with a Bachelor's degree (or greater). In addition to experiencing a lower unemployment rate than other educational levels, those with college degrees also earn more *and* have the benefit of greater job security.

[1] The list includes at least the following: Sir Richard Branson, Dean Kamen (of Segway PT fame), Mark Zuckerberg, Bill Gates, Paul Allen, Ralph Lauren, Steve Jobs, Larry Ellison, Michael Dell and Kirk Kerkorian.

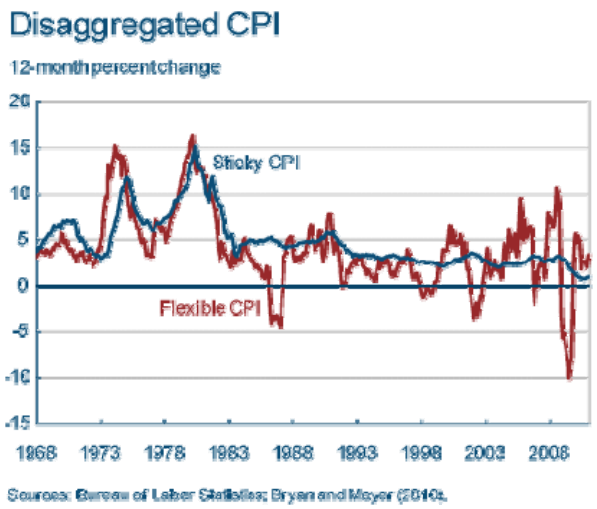
Economic Pulse – JOLTS

The daily financial market information deluge includes various macroeconomic statistics. Some of these data points are "headline" numbers, like Gross Domestic Product (GDP) or Consumer Price Index (CPI), because of their obvious and broad insight into the state of the nation's economy. Other useful statistics receive less coverage from the mass media because they provide snapshots of more limited aspects of the economy or simply do not resonate with the public at large. Examples include Industrial Production, the Chicago Purchasing Managers Index and the Fed's Beige Book releases. Still other data points are seemingly ignored completely, prompting a sense of euphoria when "discovered". The Job Openings and Labor Turnover Survey (JOLTS) falls into this category. The survey collects data on employment, job openings, hires, quits, layoffs and discharges and other separations. As the Bureau of Labor Statistics (BLS) definition states, the JOLTS statistic "...paint[s] a more complete picture of the U.S. labor market than by looking solely at the unemployment rate…[i]nformation on labor turnover is valuable in the proper analysis and interpretation of labor market developments and as a complement to the unemployment rate." A data subset series of the JOLTS measures voluntary separations, or quits, and is particularly interesting because it offers insight into the sentiment of the labor force. In particular, the quits measure illustrates workers' willingness or ability to change jobs. So, even though the unemployment rate (one of those headline numbers) has declined to 8.8%, worker sentiment has not quite kept pace, though it has shown signs of recent improvement.



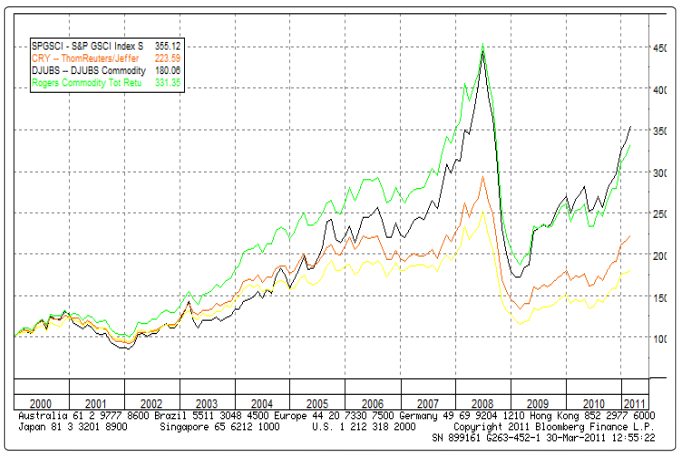
Economic Pulse – "Sticky" CPI

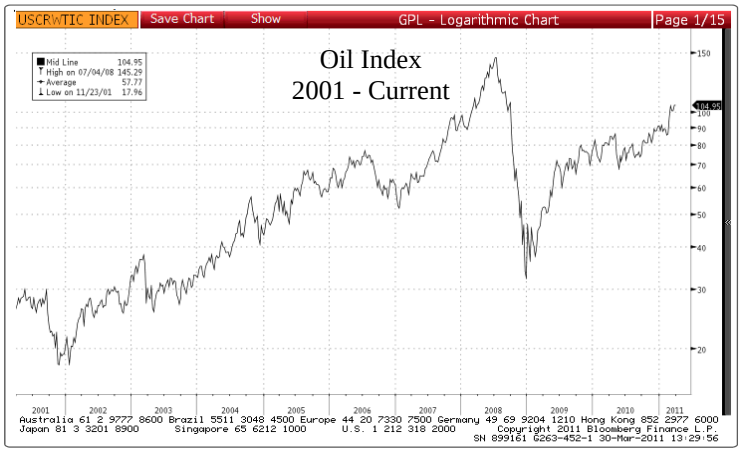
Most discussions about inflation revolve around the Consumer Price Index (CPI) or "core" CPI, which is the CPI excluding the effects of food and energy price changes. However, the CPI is not always the appropriate measure of cost increases. For example, the CPI adds little value when considering price changes at the wholesale business level. That is why the BLS publishes the Producer Price Index (PPI). The index of unit labor costs is another measure of cost increases which may be particularly useful for a company that spends a large percentage of its revenue on employees as opposed to raw materials or equipment. The Gross Domestic Product deflator is another well-established measure of broad-based inflation. And for those who want a better measure of inflation expectations, two economists at the Fed have developed a) "sticky" CPI, which measures the cost of goods in the broader CPI that change price infrequently and b) "flexible" CPI. The researchers, Brent

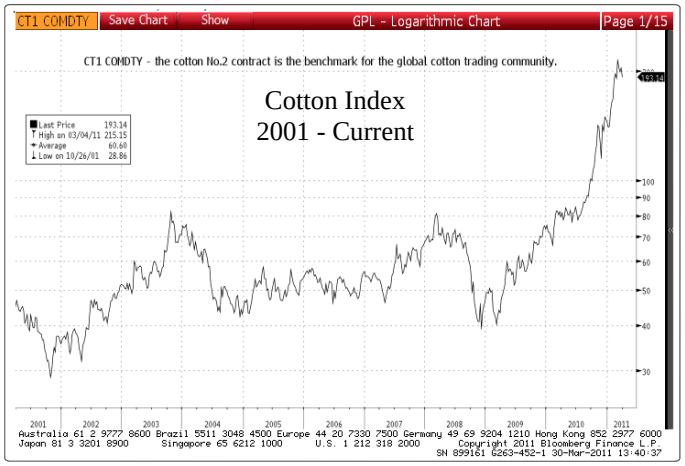


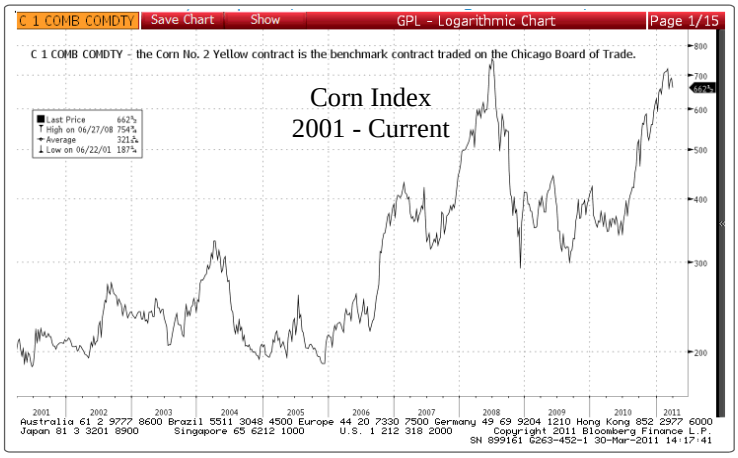
Meyer at the Cleveland Fed and Michael Bryan at the Atlanta Fed built upon an exhaustive review of the velocity of price adjustments for each of the 350 spending categories in the CPI. The study found that half of the categories exhibited price changes less than every 4.3 months while half of the categories changed prices every 4.3 months or more. Meyer and Bryan used the 4.3 month timeframe as the cutoff for distinguishing between flexible and sticky prices. In brief, the researchers found that the sticky CPI has a much higher propensity to accurately forecast inflation, especially over longer time horizons, than the flexible CPI.

Commodity Prices on the Rise









The top left chart illustrates the rise, decline and rebound of four different commodity indices. Each index reflects the prices of numerous commodities, from agricultural products to precious metals to energy, etc. They do not, however, share the same construction methodology (one is equal-weighted, another uses the world economic value of the commodity [energy dominates

that index], etc.) or even the same underlying basket of commodities, but they all capture the rising costs of the basic inputs needed worldwide. The remaining charts show rising prices of five selected commodities. Oil, given a final boost from political unrest in the Middle East/North Africa (MENA) region, is in triple digit territory again, corn has nearly regained its 2008 high and cotton doubled in price in less than a year. The price of a pound of coffee (unroasted bean) has risen over 90% in the last 12 months and sugar is up over 50% during the same time period. What effect these higher prices will have on consumers is dependent upon multiple factors. First, some changes in commodity prices pass through the value chain slower than others. That is, gasoline prices at the pump adjust faster than the price of corn flakes. Second, some of the commodities represent such small percentages of the product that a large input cost increase adds little to the cost of the finished product. Third, competition may prompt producers to absorb the higher costs by reducing overhead costs, implementing efficiency efforts and/or reformulating products instead of passing the cost increases on to consumers. For instance, packaged food producers have quietly reduced the amount of product sold per package – a "gallon" of ice cream might be just 9/10ths of a gallon now. Also, a switch to "green" packaging can be used to reduce the cost of packaging while simultaneously reducing the amount of product included in the package (e.g. Saltine crackers).

Perhaps the most important determinant of how higher commodity prices will affect consumers was brought to light by a member of the Cleveland Federal Reserve Board. Daniel Carroll noted that "the importance of food and energy prices to household's bottom lines is not evenly distributed across the income distribution." So, while the median household commits approximately 17% of its after-tax income to food and energy, the top quintile of the income distribution spend just 11.6% and the bottom quintile spend 44.1%. This dynamic might help explain why high-end retailers like Saks' Fifth Avenue and Nordstrom have prospered recently even as Wal-Mart has struggled.

Gross Domestic Product

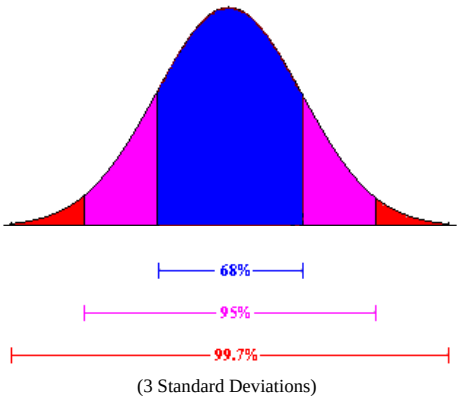
In late March, the *Bureau of Economic Analysis* (BEA) released its third and final estimate of the year-over-year growth in Gross Domestic Product for the fourth quarter of 2010. The final estimate was 3.1%, higher than the second estimate by 0.3% and higher than the consensus estimate of 2.9%. The fourth quarter GDP growth highlighted broad-based economic strength in the country, including real final sales of domestic products, which excludes the contribution of inventory changes to GDP, of 6.7%. Real final sales had not reached that level since the fourth quarter of 1998. State and local government spending weighed on GDP, though, eventually amounting to a drag of 1.5%.

COMMENTARY: Black Swan Events and Tail Risk

We have always been curious about what happens next. Attempting to predict the future has been an ancient human trait, using oracles, fortune tellers, nature, gods, mystics and others. Because the source of risk is an uncertain future and the chance that a future event might happen with adverse consequences, if we could predict the future we would eliminate uncertainty and risk. While many people think of risk as a bad four-letter word, unfortunately an economic system needs risk. If individuals and corporations did not bear risk, there would be no economic growth. Thus risk is an essential part of any economic or financial system.

In finance we use past empirical data and models in an effort to manage risk. The primary way to control risk in finance is by diversification within an asset class such as stocks, or across asset classes, such as stocks, bonds, commodities and real estate. In many countries, anyone with a fiduciary responsibility should be adhering to the prudent man rule which is to not expose investors to excessive risk. This works fairly well if risk is normal, meaning that events fall within our range of expectations, both positive and negative. More difficult to manage are events that occur outside our range of possible expectations. These would be rare, unpredictable, and extreme events, which are referred to as black swan events.

The term “black swan event” is attributed to Nassim Taleb in his best-seller titled *The Black Swan: The Impact of the Highly Improbable.* To quote his book: “Before the discovery of Australia, people of the Old World were convinced that all swans were white, a belief completely confirmed by empirical evidence.” Obviously seeing a single black swan in Australia repudiated the confirmed belief that all swans are white and showed limitations to our learning from empirical observations and experience. Black swan events are thus high risk and are sometimes referred to as tail events and tail risk. This is a statistical term referring to the left tail of a normal distribution (bell-shaped curve). The far left tail of that curve would represent rare events that have a very low probability of occurring, and thus unpredictable. Usually these events result in returns that are at least three standard deviations from the mean, meaning that there is less than a 0.13% probability of occurrence.



(3 Standard Deviations)

Black swan events can be man-made (9/11 terrorist attacks), natural (earthquakes and hurricanes), systemic (financial crisis of 2008) or government induced (wars, inflation and depressions). Since these events are outside our realm of expectations, their full impact is impossible to predict, especially their impact on the financial markets. During black swan events, uncertainty increases and investors' tolerance for risk decreases while their risk aversion increases. Investors thus require a higher return for owning a financial asset which is why asset prices decline. Since these events are rare and unforeseen, investor perceptions usually change more than reality. Another problem with black swan events is contagion or the spreading of risk. It is nearly impossible to ascertain the potential impact of a black swan event since we do not know with certainty how things are interconnected.

The 9.0-magnitude earthquake and resulting tsunami in Japan were outside their realm of expectations and forecasts, resulting in a nuclear disaster and mass destruction of lives and property. Who knows with a high degree of certainty what the final impact will be of this tragedy. While the two can't be compared directly because of the human element, the financial crisis of 2008-2009 was also a black swan event that was outside our realm of expectations. Very few thought the subprime mortgage market could nearly collapse the financial markets of the world with dramatic finance and economic consequences.

While a black swan event itself is unpredictable, what is predictable is that there will be more of them in the future. And while history may not be much of a guide in predicting the next black swan event or its consequences, one thing we have learned is that black swans do not necessarily lead to financial Armageddon. For example, few would have predicted Hitler's rise to power and his subsequent invasion of Poland in 1939. Additionally, the United States was caught off-guard by the Japanese invasion of Pearl Harbor on December 7, 1941. Yet, the stock market in 1941-1943 increased in value by almost 50% (Source: Morningstar/Ibbotson SBBI). Two years following the March, 2003 U.S. led invasion of Iraq, the stock market increased by almost 40%. The black swan event of 9/11 caused an immediate drop in the S&P 500, but it subsequently rebounded eventually increasing by more than 40%. While the stock index continued to decline for more than 12 months after the terrorist attack, and took some time to return back to its pre-9/11 value, some of the negative forces at that time were related to other issues such as the implosion of the internet bubble. Finally, we have recently seen the stock market rally substantially from the lows of March, 2009 caused by the financial crisis. It remains to be seen if this most recent rally will hold and ultimately lead to a secular (long-term) bull market in equities or if the market will move lower again and continue working its way through the secular bear market that began in early March, 2000, now over 11 years ago. Whichever course the market ultimately takes and whatever elements are associated with the next black swan event, one thing for certain is that investors will be well served to remove as much emotion as possible from any investment decisions made during these more difficult environments. The best methodology to ensure this disciplined principle is met is to formulate a fundamentally based investment policy which is consistent with one's risk tolerance; a risk tolerance that should be defined such that there is an extremely low probability of being surprised to the downside (i.e. realizing a greater loss than planned). That probability may not be three standard deviations from the mean but it should be conservatively based in order to ensure emotions do not override reality during difficult times. Speaking from many years of experience, it is much easier said than done, even knowing how crucial discipline is to investment success over the long-term.

It is a truth very certain that when it is not in our power to determine what is true we ought to follow what is most probable.
– ***Rene Descartes***

April, 2011