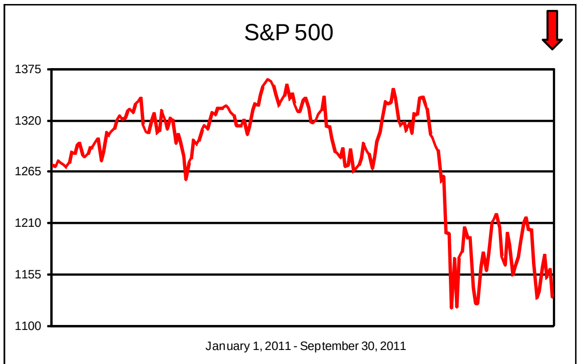
Wallington ASSET MANAGEMENT
INDEPENDENT INVESTMENT COUNSEL

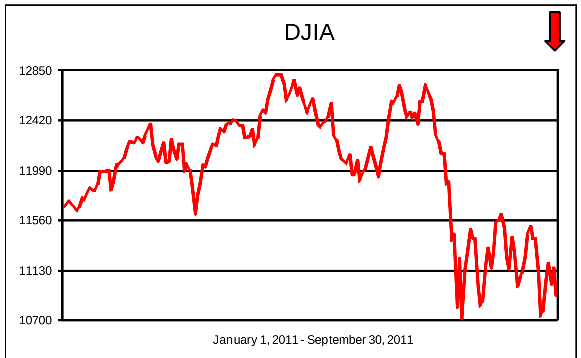
QUARTERLY REVIEW ***91st Edition*** ***2011: Third Quarter***

CAPITAL MARKETS SCOREBOARD

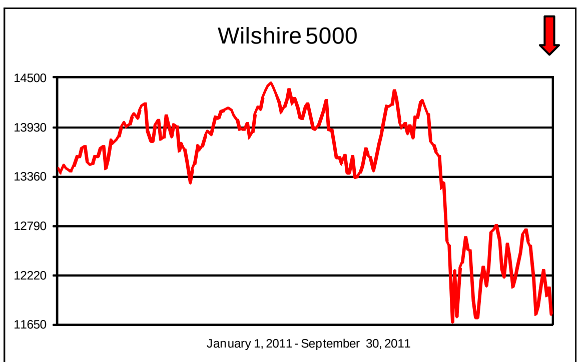
January 1, 2011 – September 30, 2011



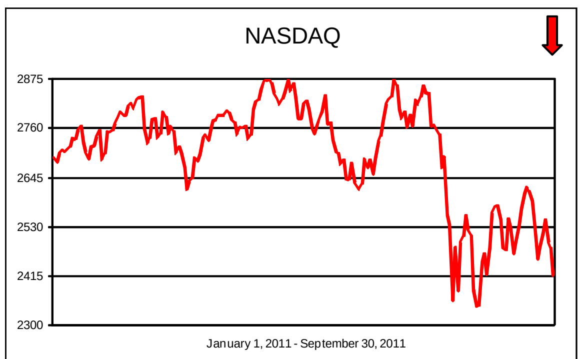
3rd Qtr -13.9% YTD -8.7%



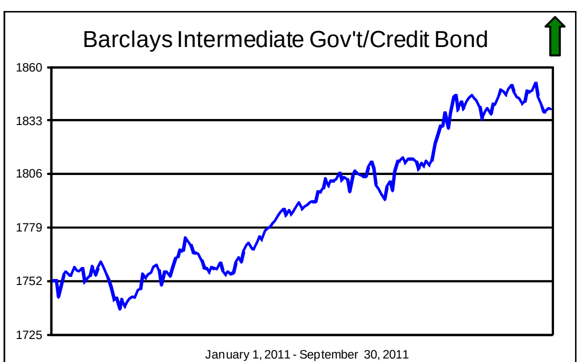
3rd Qtr -12.1% YTD -5.7%



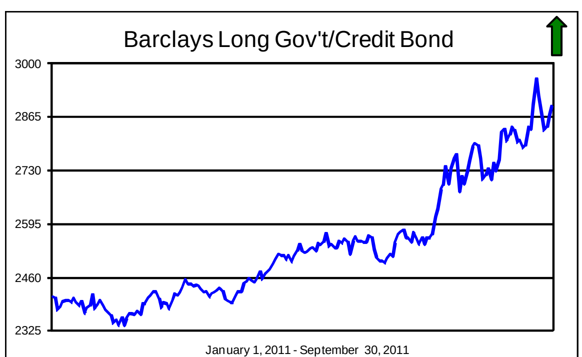
3rd Qtr -15.7% YTD -11.4%



3rd Qtr -12.9% YTD -9.0%



3rd Qtr 2.39% YTD 4.92%



3rd Qtr 15.64% YTD 19.42%

EQUITIES

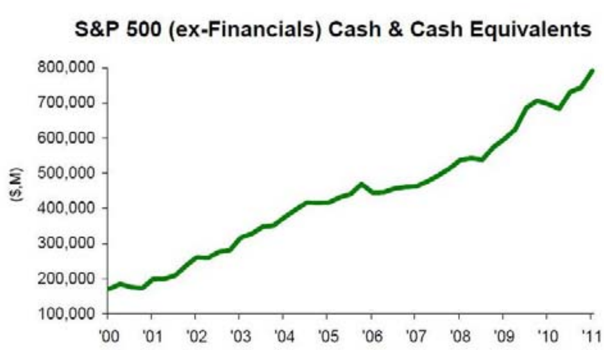
Equity Market Performance

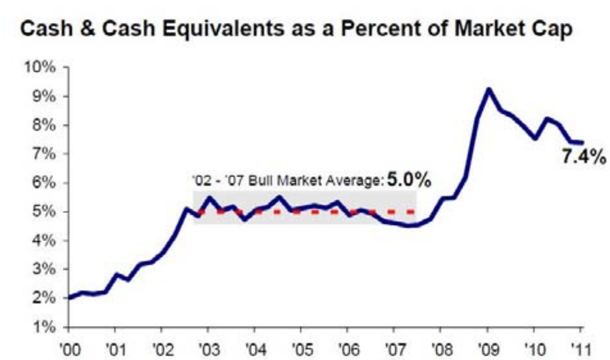
The saying, "Sell in May and go away" has certainly held true thus far in 2011. The Standard & Poor's 500 Index (S&P 500) returned 8.2% through May 2, 2011 and then subsequently fell 16.9% by September 30, 2011. The bulk of the damage occurred during the third quarter as fears of default on Greek government debt created similar concerns regarding Italian, Belgium and Spanish debt. As most of this debt in Europe is held by the banks, any potential markdowns of the fair value of these obligations raised concerns over solvency of European banks and, hence, the possibility of another recession similar to 2008. Another recession would disproportionately impact the cyclical sectors of the economy, thus explaining the exceptionally weak performances of sectors such as Materials, Energy, Industrials and Financials. One notable exception to this trend was the relatively strong performance of the Information Technology sector. Technology companies continue to benefit from the migration to "cloud computing" technology, which delivers tremendous productivity benefits for their customers and for technology companies own internal operations. Many technology companies have also shifted their revenue profile from volatile large deals to predictable multiyear deals, which deliver more consistent earnings. Finally, technology companies have amongst the strongest balance sheets in the S&P 500 and have been particularly aggressive in repurchasing their own shares. Including dividends, the S&P 500 returned -13.9% for the quarter and -8.7% for the year.

S&P 500 by GICS Sector	Price Return (%)	
	3Q11	**YTD**
Energy	-20.8	-12.6
Industrials	-21.5	-16.1
Health Care	-10.5	0.8
Consumer Discretionary	-13.3	-6.8
Materials	-25.0	-23.0
Telecommunications	-9.2	-5.2
Information Technology	-8.0	-6.5
Financials	-23.1	-25.9
Consumer Staples	-5.0	1.0
Utilities	0.4	7.2
S&P 500 Index	**-14.3**	**-10.0**

The Financial Health of Domestic Corporations

Corporations in America made difficult decisions during the past recession. These decisions primarily revolved around ways to make or keep the company profitable. One of the difficult actions taken for many was to reduce their respective labor forces, which obviously caused unemployment to rise over the past few years. Other actions were also taken to enhance margins and as a result the same dollar of revenues caused profits to be greater. Birinyi Associates produced a few charts (below) that not only show the level of cash and cash equivalents held by non-Financial corporations, but also how much that



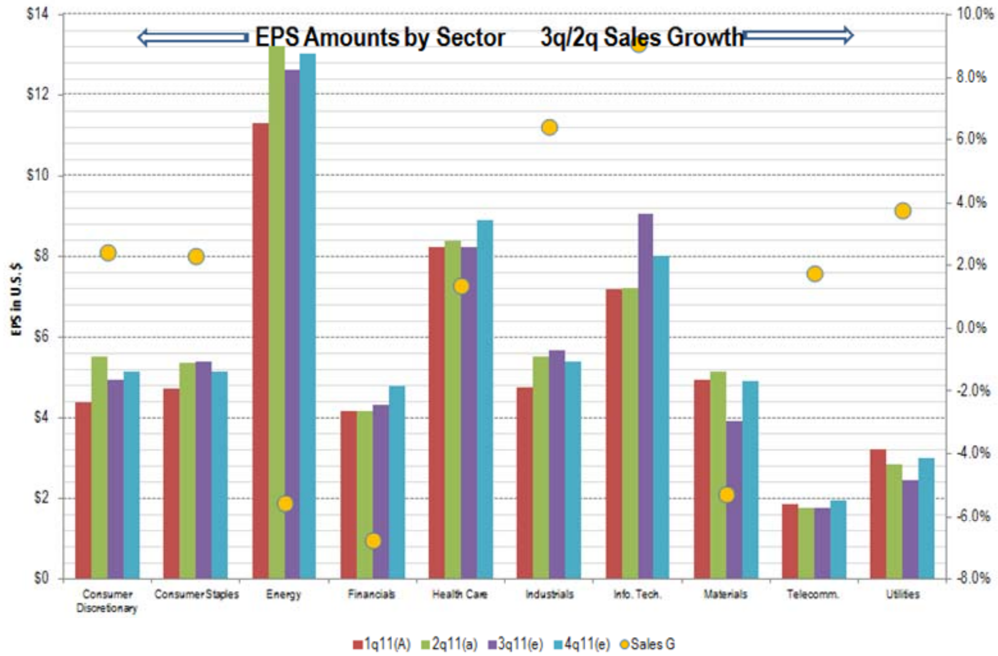


Source: Birinyi Associates, Inc.

cash represents as a percentage of market capitalization. As one would expect, the low market capitalization of corporations in March of 2009 caused the cash percentage to peak. The 7.4% reading was in July (when this chart was produced) and had declined to this level due to the stock market increase. Significant corporate cash opens the door for increased dividends, expanding investment in plant and equipment, debt reduction, share repurchase and merger and acquisition activities.

Earnings Growth

The market enters the third quarter earnings season with relatively muted expectations compared to the second quarter. Many sectors of the market delivered strong sequential growth in the second quarter, but this is part and parcel of normal seasonality. The economy typically slows in the third quarter as families take summer vacations and spend more time outdoors than shopping inside malls.

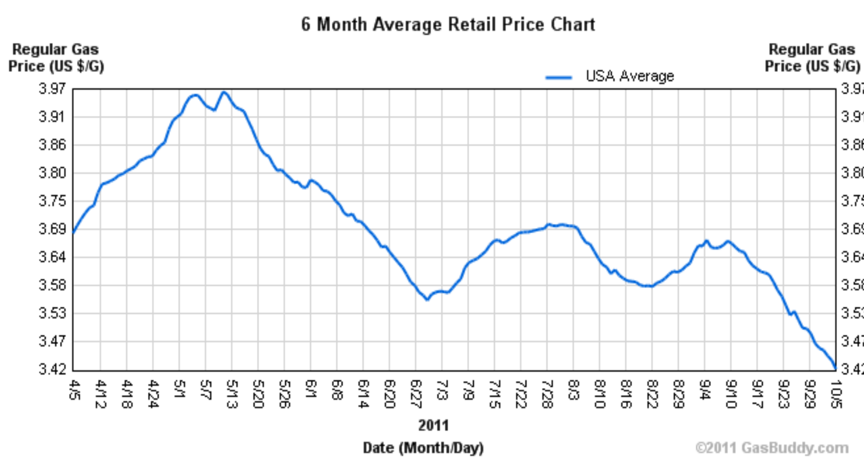


Source: Wallington Asset Management, The Bloomberg

The Energy and Materials sectors were amongst the worst performing sectors in the third quarter because of an -11.6% drop in commodity prices (as measured by the S&P Goldman Sachs Commodity Index) during the quarter. This drop in commodity prices partially explains the significant sequential drop in earnings for the Energy and Materials sectors. The fourth quarter is typically the strongest quarter of the year due to holiday spending. In addition, the drop in energy prices in the third quarter may, on the margin, help companies achieve their fourth quarter earnings objectives due to lower input costs. Also, businesses this year have an additional incentive to spend on capital equipment as the Section 179 accelerated depreciation tax benefit is set to expire on December 31, 2011, assuming it is not extended in some manner. Fourth quarter growth expectations relative to the third quarter expectations are not set particularly high compared to normal seasonality, so the upcoming earnings and guidance season will be an important gauge of the underlying health of the global economy and future corporate profitability.

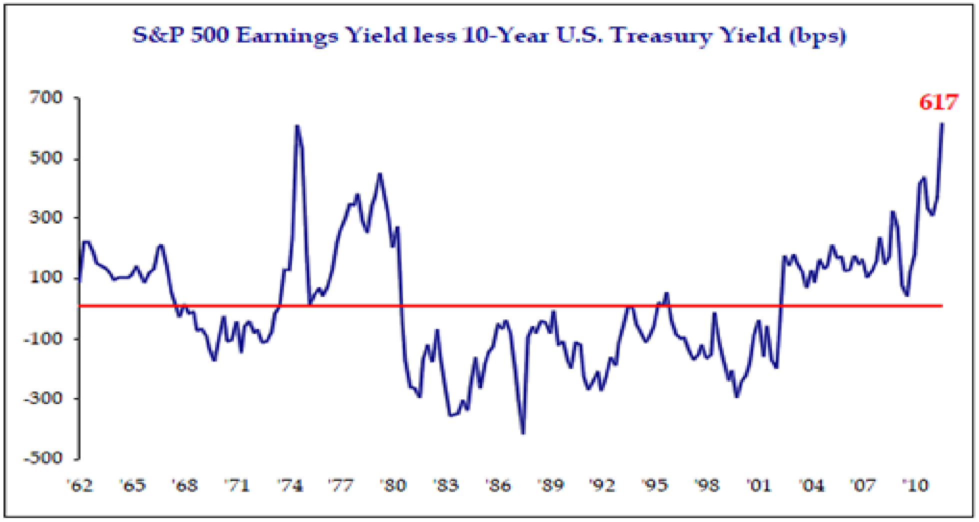
Commodity Prices – Input Costs

Almost all commodities dropped in the third quarter on fears of an economic recession. From this year's peak, retail gasoline prices have fallen almost $0.55/gallon. According to the U.S. Energy Information Administration, the U.S. consumes approximately 378 million gallons of gasoline per day. On an annual basis, this price drop translates into an additional 75 billion dollars into the U.S. consumers' pocket or a 0.5% annual benefit to GDP**.** The $0.30/gallon drop in distillates products such as diesel may translate into an additional 0.3% annual benefit to GDP. As mentioned above, the drop in energy prices (along with the decline in other commodity prices) has paved the way to support earnings growth during the third quarter.



Are Equities Cheap or Are Bonds Expensive?

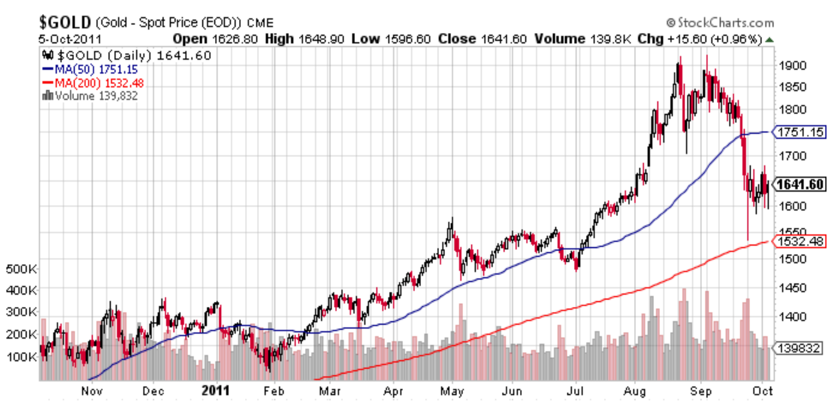
Risk premium is simply the rate of return required over a risk-free asset such as U.S. Treasury bonds to compensate investors for the additional volatility of returns that is associated with other asset classes such as equities. The S&P 500 earnings yield is the inverse of the Price/Earnings Ratio (PE). For example, if the PE of the S&P 500 is 12, this would equate to a 1/12 or 8.3% earnings yield. If the 10-year U.S. Treasury bond is yielding 2%, this would imply a 6.3% risk premium (8.3% - 2%) for the S&P 500. At the end of the third quarter, the risk premium as measured by this metric hit almost a 40 – year high, indicating that stocks were substantially undervalued. However, note that the risk premium in 1974 was also exceptionally high at 6% or 600 basis points (bps) and ultimately declined to negative 300bps in 1982. According to Ibbotson, over this 9-year period, stocks returned 9.59% per year, an investment in T-Bills returned 8.6% per year and an investment in intermediate Treasury bonds returned 8.4% per year. A large equity risk premium in 1974 simply indicated that bonds were more expensive than stocks, not necessarily that stocks were exceptionally cheap. On a risk-adjusted basis, an investment in U.S. Treasurys outperformed stocks and intermediate Treasury bills. Perhaps the exceptionally high risk premium today is an indication of a return to the 1970s when the risk-free rate rose substantially to compensate investors for higher inflation. Or perhaps earnings are overstated and the risk premium is actually lower than it is being calculated. Time will tell, but one asset-class is clearly mispriced.



Source: Strategas Research Partners

Commodity Prices – The Performance of Gold

Gold prices rose approximately 8% in the third quarter, despite a 6% rally in the U.S. dollar. At one point, gold had risen 25% in the quarter, but was unable to maintain its performance given the relentless rise in the U.S. dollar, especially in the month of September. Gold continues to benefit from several trends. Government deficits around the world continue to grow and central banks are pressured to issue more currency to absorb this additional debt, which could prove inflationary. The uncertainty around the health of the financial system has caused investors to allocate a portion of their net worth to physical assets such as gold. The proliferation of securities such as Exchange Traded Funds (ETFs) has made it much easier for investors to gain exposure to the commodity, which has no doubt accelerated demand. Also, Asians have a strong historical affinity to gold and their rising wealth translates into additional demand for gold metal. Finally, despite rising demand for gold, production has remained relatively flat when measured in metric tons/year over the last decade.



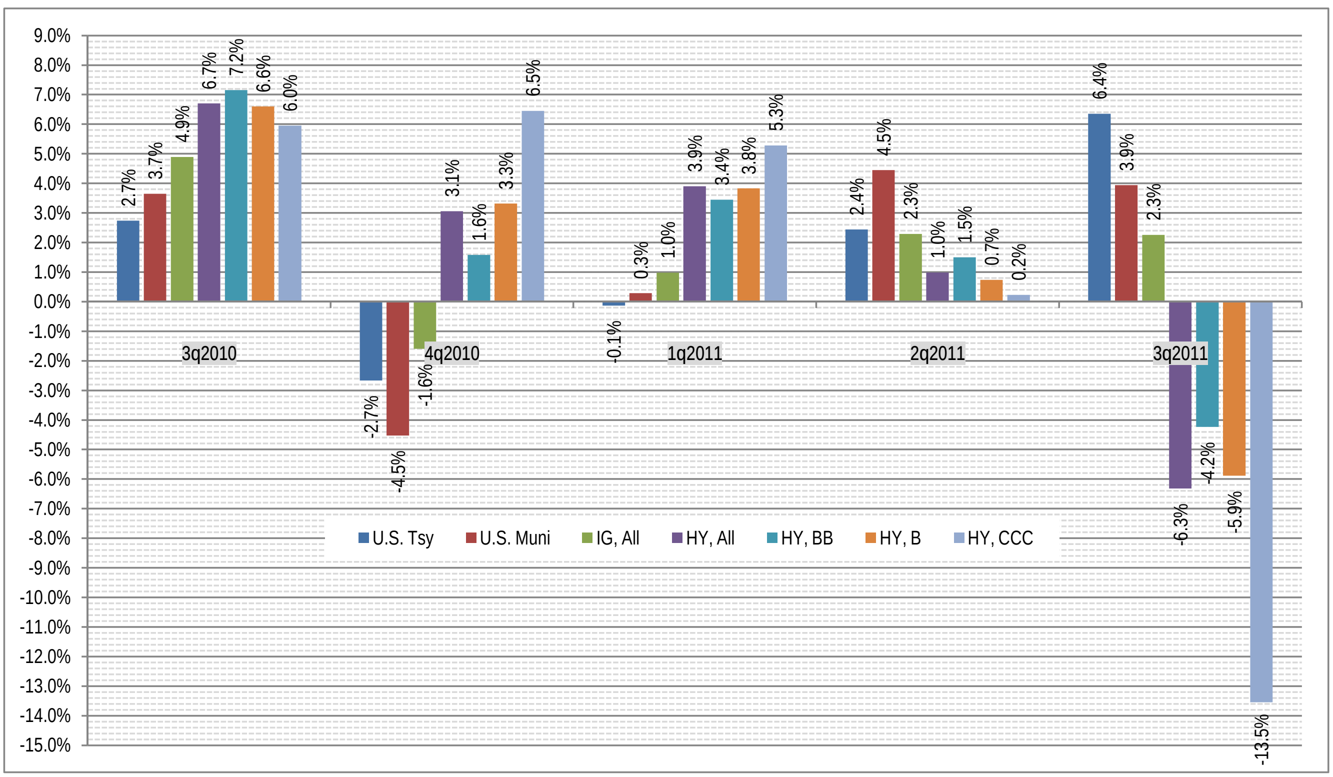
ECONOMICS AND FIXED INCOME

Fixed Income Market Performance

In the newsletter for the first quarter of 2011, we noted:

> [T]he various classes within the fixed income market showcased the "risk on/risk off" nature of investor sentiment…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).

And in the second quarter missive, we wrote that the "…risk-on/risk-off dynamic remained in force throughout the…quarter, although risk-off predominated." That driving dynamic continued in the third quarter of 2011, but with a twist – the bearish, risk-off sentiment greatly intensified. The newly severe negative sentiment is clearly evident in the performance of the two credit extremes available to fixed income investors, namely U.S. Treasury bonds and the lowest rated tranche of the high yield/junk bond market, CCC bonds. U.S. Treasury bonds provided holders a return of 6.4% according to Bank of America-Merrill Lynch's *U.S. Treasury Master* index, driving ten-year yields to their lowest levels since the 1960s and beating their riskier counterparts by a stunning 19.9%. In fact, the 13.5% decline in the quarter wiped out investment gains posted by the CCC index since July 2010 and brought high yield debt issuance to a virtual halt. Much of the Treasury outperformance resulted from gains in long-maturity bonds after the Federal Reserve indicated that it would lengthen the duration of its fixed income holdings ("Operation Twist"). Finally, investment grade-rated debt (AAA to BBB-) gained 2.3% in the quarter; with rates so low, high grade debt issuance continued apace.

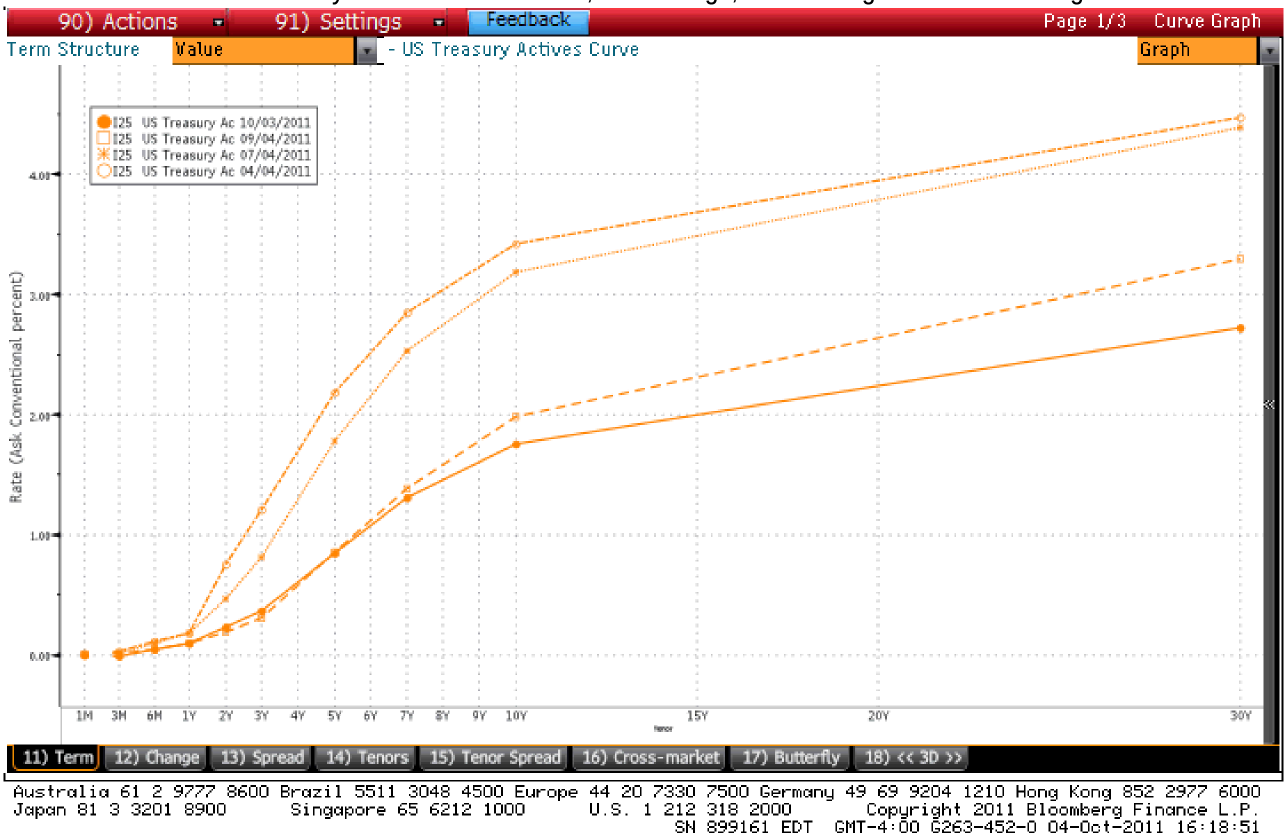


Sources: Bank of America-Merrill Lynch, The Bloomberg

Exciting News for the U.S. Treasury Bond Market

The U.S. Treasury market provided an unusual number of major headlines this quarter. In the first week of August, Standard & Poor's downgraded its assessment of the United States' creditworthiness from AAA to AA+. The news provided fodder to market commentators, politicians and analysts of all stripes, but ultimately had little practical effect on demand for U.S. government debt – Treasury bonds are still the preferred security when a "flight-to-quality" occurs.

U.S. Treasury Yield Curves – Current, 1 Month Ago, 3 Months Ago and 12 Months Ago

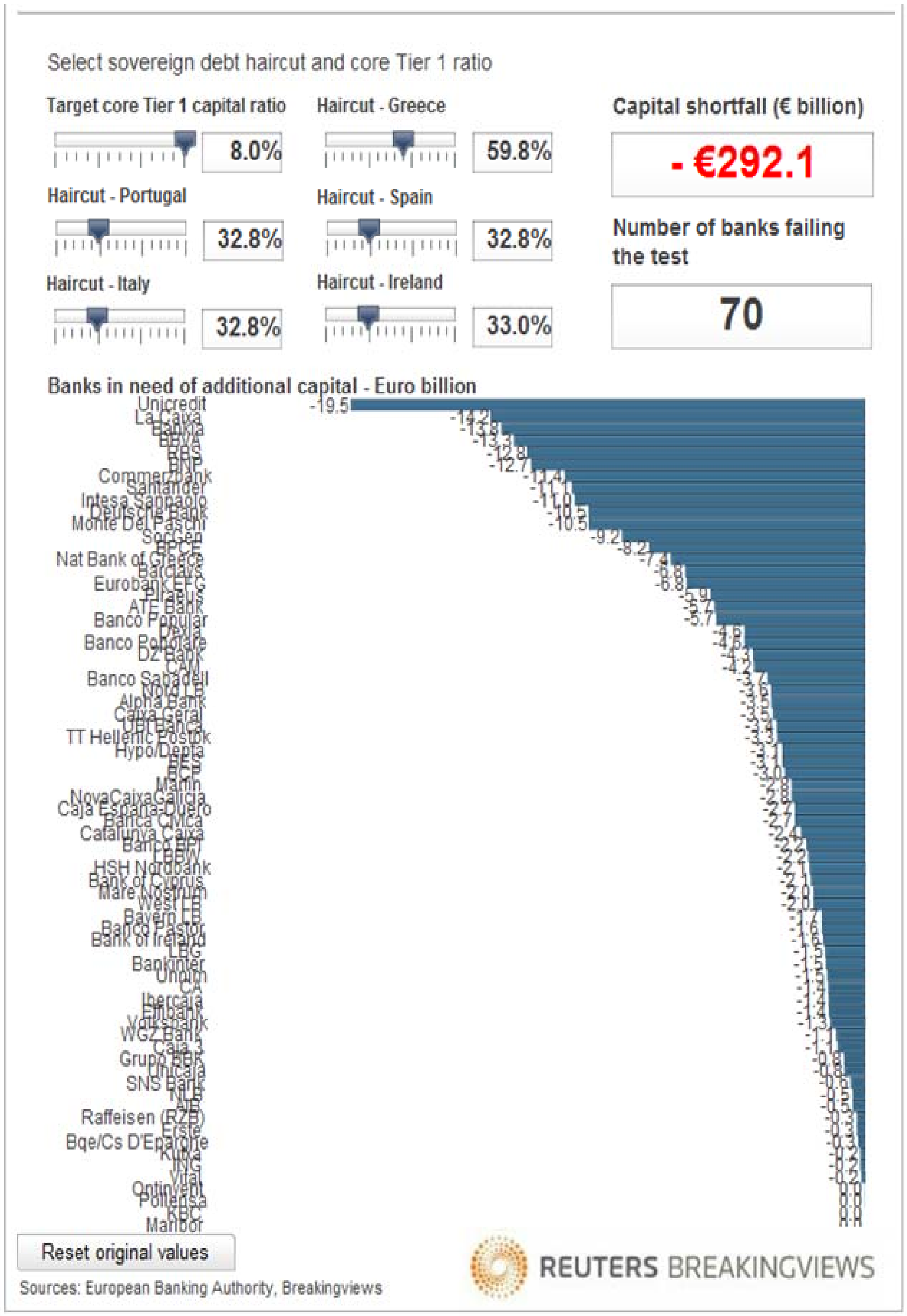


Yields on U.S. government bonds neatly illustrate the buyers' preference in times of turmoil, fear and doubt. The four curves in the nearby Bloomberg graph show the progressively lower rates market participants have demanded when purchasing Treasurys over the last twelve months. The top curve is from April 2011, the next curve down is from July 2011, the third curve from the top is from just one month ago and the lowest curve is from the beginning of September 2011. In effect, the country's borrowing costs have declined despite its growing debt load, budget impasses, the debt ceiling brinkmanship and multiple rounds of monetary stimulus. Irrespective of Standard & Poor's opinion, then, bonds backed by Americans' tax dollars remain the world's risk-free asset and in high demand.

Economic Pulse – Euro Zone Banks Suffer from Sovereign Debt Crisis

Uncertainty may produce optimism at some point in time, but it has only bred fear and trepidation in recent memory. Thus, whether or not Greece will default on its debt has become a high profile question in the financial markets. And since the odds of default are generally considered high, the related question is: What is the size of the loss Greek bond holders must take when Greece defaults?

The answer to the first question rests on the breadth and depth of measures the European Monetary Union leaders and members take to rescue Greece, European banks (who own Greek debt) and themselves. Note, though, that Greece still has a primary budget deficit, i.e., its budget is still negative, even if it has zero debt service costs. In addition, its citizens are adamantly opposed to austerity measures. Looking at the Credit Default Swap (CDS) market for Greek debt, which reflects market sentiment, it has been building in a probability of default of over 90%, very high odds that the default will occur.



Source: Thompson Reuters, retrieved on 10/07/2011
http://graphics.thomsonreuters.com/11/07/BV_STRSTST0711_VF.html

The answer to the second question on how much of a write-down Greek bond holders will take depends upon who is asked. Or, more appropriately, it depends upon how high that entity's total exposure is to Greece. BNP Paribas and Societe Generale have both marked their Greek debt down by 21%, while other lenders with smaller exposures have taken write-downs of 40% to 50%. A JP Morgan analyst reckons that Greek bondholders will only receive 40 cents on the Euro (€). Further, the European banks also hold a material amount debt issued by other problematic Euro zone countries (Portugal, Italy, Spain, etc.), which the banks may also need to write-down to more realistic levels. And since write-downs decrease a bank's required regulatory capital levels, the losses could lead to mandated capital infusions in the €200 billion range, according to analysts' estimates. Alternatively, the Euro zone capital infusion calculator from Thomson Reuters allows users to calculate Euro zone bank capital shortfalls by customizing the assumed write-down levels (or "haircuts") for each of the weakest European Monetary Union countries. Based on the assumptions shown in the accompanying graph, including a required capital level of 8%, the banks will need approximately €300 billion. Although either value is manageable, the resulting shareholder dilution could, in effect, force a European bank's equity owners to absorb some of the financial loss caused by the profligacy of Greece and the other poorly managed Euro area countries.

Municipal Bond Market in Focus

In the Bank of America-Merrill Lynch index chart on Page 5, which reflects investment performance, it is interesting to note that municipal (muni) bonds outperformed every fixed income class except Treasurys. This occurred in a year when billions of dollars of defaults had been predicted by at least one high-profile analyst and as state and local governments deal with tepid economic growth as well as the end of special Federal support programs. While municipalities have had to begin making concessions to issue debt, the major stumbling block has been the low absolute level of market interest rates, not financial concerns. The following compendium of headlines succinctly conveys the positive environment for muni bonds in the third quarter:

Muni Debt in Longest Winning Streak Since '02

States Cut Debt-Service Costs

Investors Add $600 Million to U.S. Muni-Bond Funds

Investors added about $600 million to U.S. municipal-bond mutual funds in the week through yesterday, Lipper US Fund Flows said today. It was the fourth straight week of inflows.

Chicago Tower Tops Muni Defaults in '11

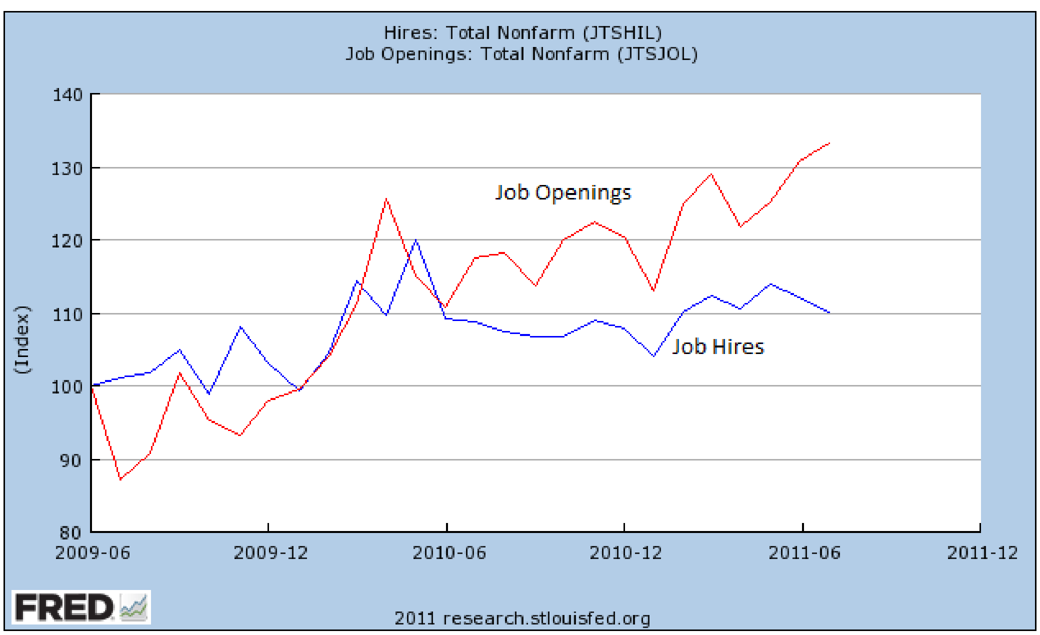
This housing development for retirees represents the largest muni default of 2011 at a modest $229MM.

Supercommittee May End Muni Tax Exemption

Those who derive a tax benefit from owning municipal bonds need not despair about the potential end of the tax exemption yet. The proposition, which gained prominence when President Obama released his jobs creation and deficit reduction budget proposals, was widely considered dead on arrival. Time will tell if the end of the tax exemption comes to pass and whether or not existing municipal bonds will be grandfathered. Most municipal bond analysts are of the opinion if there is a loss of the exemption, it will only apply to newly issued bonds, issued after a certain future date. It is important to note that while the federal government is using this as a potential source of deficit reduction, the resultant cost to state and local municipalities could be dramatic due to the increase in interest rates that would result from no longer being able to offer investors tax-free income. Obviously municipalities would either have to cut costs or pass along to taxpayers the increase in their funding costs. Either option could have a significant effect on the economy and prove regressive in nature due to the impact that could be felt by the lower and middle income classes.

Unfilled Jobs

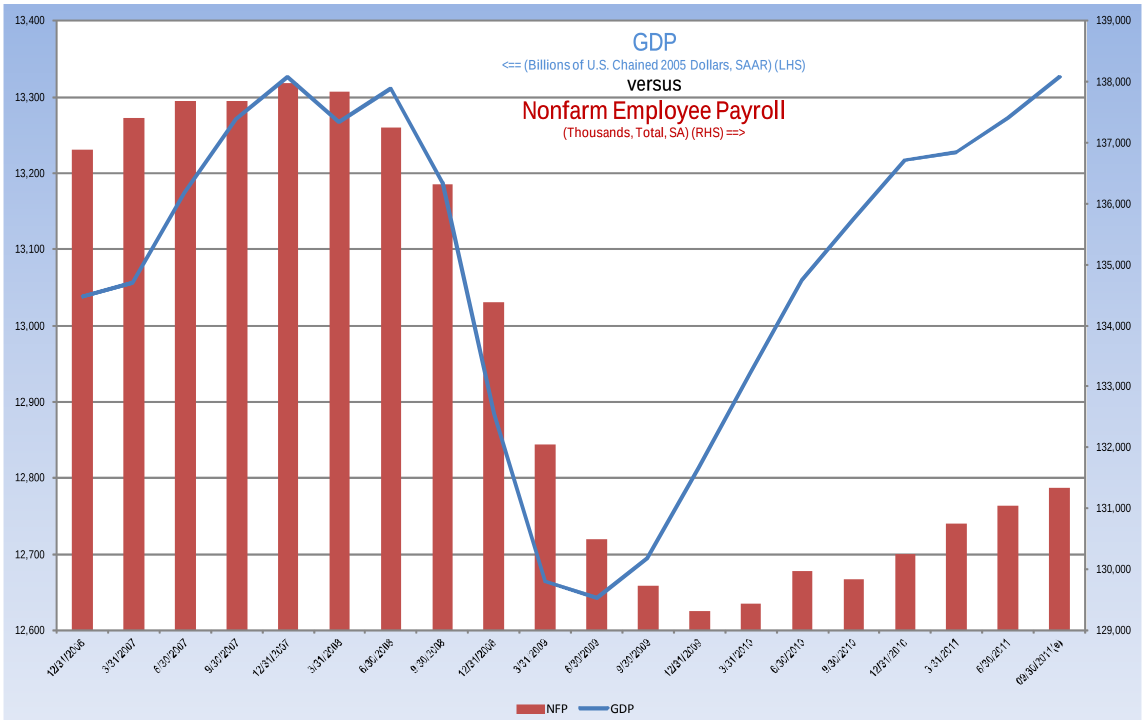
An important feature of this recovery is the growing gap between job openings and jobs being filled. There are several possible explanations for this trend. Many of the job openings require sophisticated technical or legal skills, yet many of the unemployed are workers previously employed in the construction industry. An additional challenge: workers are less geographically mobile than in the past because they are unable to sell their homes or their mortgages exceed the value of their homes. Technology such as video conferencing may help bridge part of this gap, but demographics may exacerbate this trend going forward as highly skilled baby boomers start to retire. The first baby boomers reached the age of 65 starting on January 1, 2011 and many more will follow for the next 19 years. Not all will retire at this age



considering their retirement savings have recently contracted, the retirement age for Social Security benefits ranges from 66 to 67 and the life span of many baby boomers has increased.

Gross Domestic Product (GDP) Now Exceeds 2007 Peak Despite Employing 6.7 Million Fewer Workers

In business, and in the world at large, connectedness appears to be rising. For instance, equity prices throughout the world have once again started moving as a group, Europe's sovereign debt issues have endangered the region's banks and



Source: Bureau of Labor Statistics, Bureau of Economic Analysis; Concept: Strategas Research Partners

telecommunications via the Internet, Twitter and viral videos have begun to inspire the citizens of countries ruled by repressive regimes to demand greater freedoms. Less dramatically, a plot of the Gross Domestic Product (GDP) of the U.S. versus the Nonfarm Employee Payroll numbers highlights the interconnectedness of the country's economy in a counterintuitive manner. GDP in the third quarter of 2011 exceeded the 2007 peak *even though* 6.7 million fewer people were employed at the end of September 2011 versus September 2007. The results reflect the fact that in recent years GDP has become more connected, at least in part, to a combination of increased worker productivity and stagnant wage growth which has led to historically high corporate profit margins. The above graph provides an excellent depiction of why the economic situation today has been described as a "jobless recovery".

COMMENTARY: Don't Shoot the Messenger: It's Not S&P's Fault

One of the most talked about news events this past quarter was the downgrading of U.S. Treasury debt from the coveted AAA rating to AA+ by Standard & Poor's (S&P). This has caused a lot of controversy in the U.S. and throughout the world as much of the U.S. debt is held by foreign investors. Obviously, the Obama Administration lambasted S&P for the downgrade; but this would be expected. Any time sovereign debt has been downgraded, politicians have regularly publicly chastised the ratings agencies involved as happened in Greece, Ireland, Portugal, Japan and numerous other countries.

Ratings agencies have few friends in the business world, but bond ratings play a critical role in the capital markets. They are designed to measure the creditworthiness of the issuer and their ability to repay debt, both principal and interest. Investment grade bonds have ratings of AAA, AA, A and BBB by S&P and Aaa, Aa, A and Baa by Moody's, the other dominant ratings agency in the U.S. Each rating below AAA is further subdivided: S&P has a + or - attached to each rating and Moody's has a 1, 2 or 3. A third agency, Fitch, has ratings similar to S&P.

It is important for issuers to have their bonds rated investment grade because the better the rating, the lower the interest rate (cost of their debt). Also, many institutional investors are not allowed to invest in non-investment grade bonds. The non-investment grade bonds would have ratings of BB and B by S&P and Ba and B by Moody's. There are also C rated bonds that are highly speculative and D ratings for bonds in default. Prior to the 1980s, the only non-investment grade bonds available were investment grade bonds that had been downgraded. Since then, the high-yield bond market, also referred to as the junk bond market, has been developed and is now a major part of the capital markets.

In the U.S., these bond ratings agencies have been around for more than a century. So why don't they have any friends? First, the rating business in the U.S. is dominated by three firms, Moody's, S&P and Fitch. Others have been officially sanctioned by the government as ratings agencies, but these three firms dominate, with 95% of the ratings business. Ironically, a small ratings firm, Egan-Jones, downgraded U.S. debt three years ago but it was a non-event in the bond markets. Second, many think that a huge conflict of interest exists because the issuer pays the ratings agency for a rating on their bonds. Many question how objective the ratings agency can be when paid by the issuer. Third, the rating process is subjective and not totally transparent. And fourth, the ratings agencies have made mistakes by maintaining investment grade ratings long after they should have been downgraded. Enron, Lehman Brothers and Icelandic and U.S. banks are corporate examples of lateness. But overall the performance in rating corporate bonds has been good. In rating sovereign debt, the performance is not as good, perhaps because of the political backlash and negative publicity involved. Greece, Ireland and several other countries have been slow to get downgraded. The ratings agencies' biggest mistake was giving some subprime mortgage securities the AAA rating until prices and quality dropped dramatically. They lost a lot of credibility in the subprime mess.

There is a lot of pressure in the U.S. and Europe to reduce the influence of the ratings agencies. In fact, the Dodd-Frank financial regulatory act passed in 2010 requires that all mention of ratings agencies in federal documents and legislation be removed. That may or may not change the system. If not, there needs to be more competition for S&P, Moody's and Fitch. But it will be difficult to take business from the oligopoly that exists. Another possibility would be to have investors pay for the ratings, as opposed to the issuers. If ratings have value, investors will pay because the ratings replace the need for in-house analysts. Up to now, investors have gotten a free ride and have relied heavily on bond ratings.

What if ratings were to disappear? The global financial markets would then determine creditworthiness and it would be reflected in bond yields and credit default swap premiums, which are premiums paid for insurance against default. In fact, in numerous cases, including Greece, Portugal, Ireland and several other countries, bond yields and credit default swap premiums have risen well before (sometimes months before) the ratings agencies have downgraded bonds. The problem with market-based signals is that some bonds don't have much liquidity and are not traded often. Also, sometimes changes in yield and premiums are also wrong, driven by rumor and speculation. Bond ratings issued by the rating agencies are not influenced by market prices.

U.S. debt was rated AAA since 1917. The downgrade was a humbling experience. Was it justified? Probably so, based on recent trends and events. The political battle over raising the debt ceiling convinced S&P and millions of others that it will be difficult politically to devise a long-term plan to control federal spending and/or raise revenue. Currently, federal spending is 25 percent of GDP and tax revenue is 15 percent of GDP. Those numbers are not sustainable, long-term or medium-term. Something dramatic has to be done; the recent debt ceiling legislation did not begin to address the problem.

The repercussions from S&P's downgrade have not been significant thus far. For one thing, Moody's and Fitch did not join S&P in the downgrade. Also, the change in rating was cosmetic, from AAA with a negative view to AA+, still a long way from non-investment grade status. In fact, yields on Treasury bonds fell after S&P's downgrade. For example, the yield on 10-year Treasury bonds fell from 2.8 percent to below 2 percent at its low. However, this was due more to the European crisis and the increased probability of a double-dip recession in the U.S. and globally.

The important issue for the U.S. is to make sure that this downgrade is not the start of a secular trend as in Japan. It is even possible for the U.S. to regain its AAA rating, as happened in Canada and Finland. This could take a few years but it is possible and necessary because there is no viable alternative to the $10 trillion of marketable U.S. Treasury securities; nothing else can provide their liquidity and safety. Therefore, it really is appropriate to spare S&P (at least to some degree) the scrutiny undertaken by Congress and the Justice Department. S&P was only the messenger of a vital wakeup call for the U.S. as the downgrade can be a positive in the long run if it helps drive the U.S. to get their fiscal house in order.

"There are but two ways of paying debt: Increase of industry in raising income, increase of thrift in laying out."
Thomas Carlyle (Scottish Historian and Essayist, 1795-1881)

October, 2011