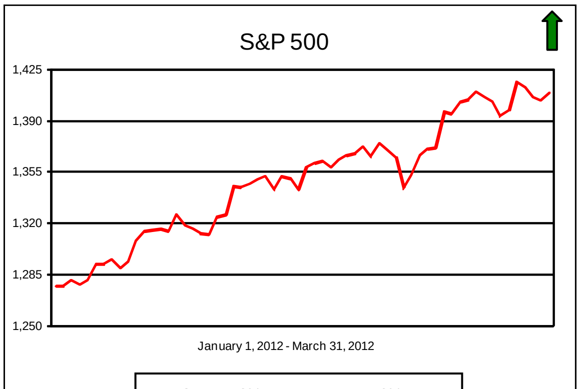
Wallington ASSET MANAGEMENT
INDEPENDENT INVESTMENT COUNSEL

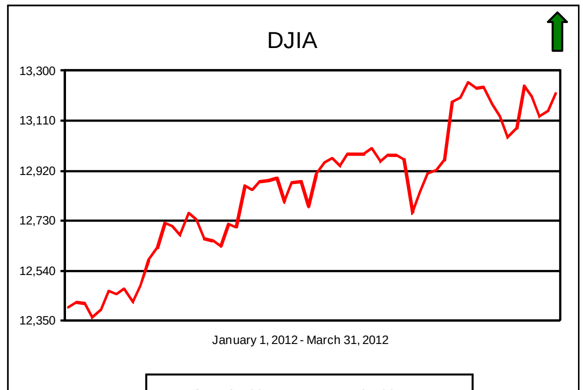
QUARTERLY REVIEW *93rd Edition* *2012: First Quarter*

CAPITAL MARKETS SCOREBOARD

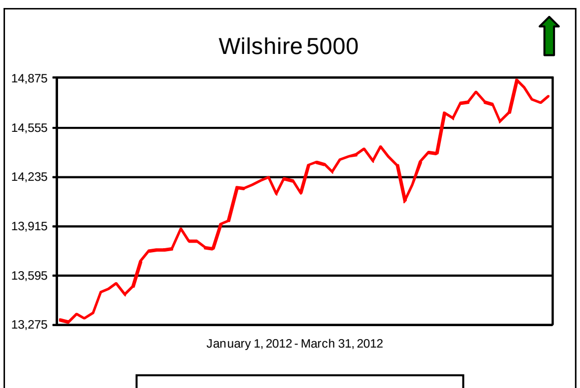
January 1, 2012 – March 31, 2012



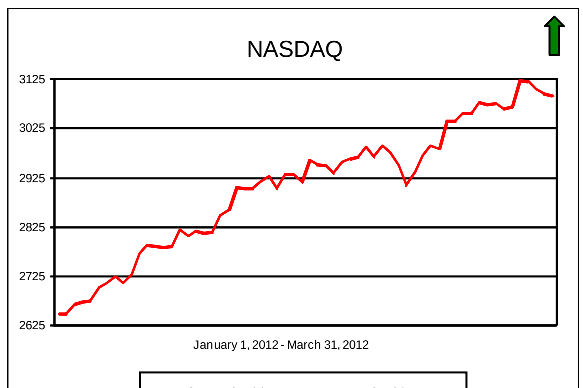
1st Qtr 12.6% YTD 12.6%



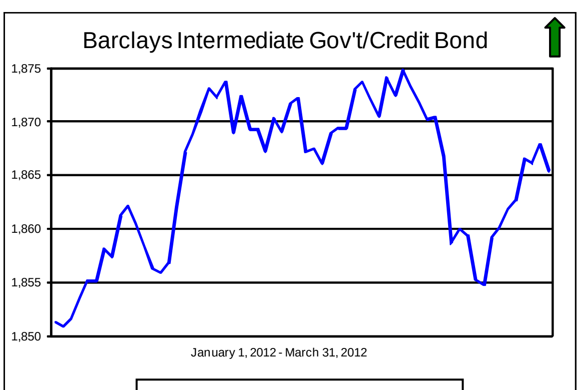
1st Qtr 8.1% YTD 8.1%



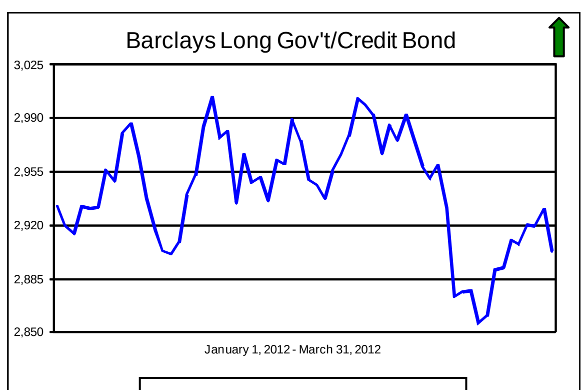
1st Qtr 12.5% YTD 12.5%



1st Qtr 18.7% YTD 18.7%



1st Qtr 0.6% YTD 0.6%



1st Qtr -2.1% YTD -2.1%

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EQUITIES

Equity Market Performance

S&P 500 by GICS Sector	Price Return (%)	
	1Q12	**YTD**
Energy	3.4	3.4
Industrials	10.7	10.7
Health Care	8.4	8.4
Consumer Discretion	15.5	15.5
Materials	10.6	10.6
Telecommunications	0.6	0.6
Information Technology	21.2	21.2
Financials	21.5	21.5
Consumer Staples	4.8	4.8
Utilities	-2.7	-2.7
S&P 500 Index	**12.0**	**12.0**

The Standard & Poor's 500 (S&P 500) Index performed exceptionally well during the first quarter of 2012 providing a price return of 12%. Financials posted strong returns of 21.5% on the heels of a 10.4% return in the fourth quarter of 2011. A key driver for this return was the release of the Federal Reserve's "stress test" which indicated that U.S. banks had the cushion to absorb losses from Europe and/or withstand larger losses in their real estate portfolios. Further helping this sector was the warm weather, which may have accelerated demand for auto and housing loans. Another significant contributor to S&P 500 returns was the Information Technology sector's return of 21.2%. This sector continues to benefit from the growth of smart phones, data analytics and cloud computing. The Technology and Financial sectors constitute almost 1/3 of the S&P 500 Index, so the strong performance of these two sectors contributed half of the S&P 500's 12% return. Investors, in general, expressed a strong preference for economically sensitive sectors during this period and may have funded these purchases by selling less economically sensitive sectors such as Utilities and Telecommunications. Utilities posted a return of negative 2.7% and Telecommunications posted a return of just 0.6%.

The Market vs. the Economy

March 9, 2012 marked the three-year anniversary of the March 9, 2009 market low. All the major asset classes have experienced rallies during this time frame. The S&P 500 returned 29% per year, gold's return was 22.5% per year and longer-term U.S. Treasury returns were 8% per year. The role of the government over this period cannot be ignored. On this anniversary date, total government debt was 42% higher and assets on the Federal Reserve's balance sheet assets were 43% higher than three years prior. Whether the economy or the markets can sustain themselves without government intervention remains to be seen. There are some signs that private employment and capital expenditures are rising, which historically has been the basis for a self-sustaining economic and market recovery (i.e., the expansion phase of the economy). However, the odds of a significant pullback in government stimulus policies appear low considering this is an important election year. Furthermore, the expansion appears fragile given an increased headwind from higher gasoline prices and relatively high levels of unemployment.

A Study in Contrast: March 9, 2009 vs. Today

	March 9, 2009	Today	Pct. Chg.
Oil ($/bbl)	47.1	106.7	126.7%
S&P 500 Market Cap ($Bn)	5,895	12,371	109.9%
S&P 500 Index Price	676.5	1365.9	101.9%
S&P 500 Operating EPS (TTM)	49.51	96.34	94.6%
S&P 500 Operating Margin	4.7%	9.1%	92.6%
Gold ($/oz.)	922.0	1700.7	84.5%
Fed Balance Sheet Assets ($Bn)	2,012	2,886	43.5%
Total Gov't Debt ($Tn)	10.89	15.46	42.0%
Forward P/E	9.8x	13.4x	36.7%
12 Mo. Rolling Budget Deficit ($Bn)	923.4	1227.2	32.9%
Nominal GDP* ($Bn)	13,894	15,472	11.4%
Real GDP* ($Bn)	12,663	13,497	6.6%
Trailing P/E	13.7x	14.2x	3.6%
S&P 500 Revenue Per Share (TTM)	1,042.5	1,053.0	1.0%
Nonfarm Payrolls (Thous)	132,038	132,697	0.5%
US 10 Yr. Yield	2.86%	2.01%	-29.6%
Corporate Bond Credit Spreads (bps)	597	202	-66.2%

*GDP includes 1Q 2012 Est.

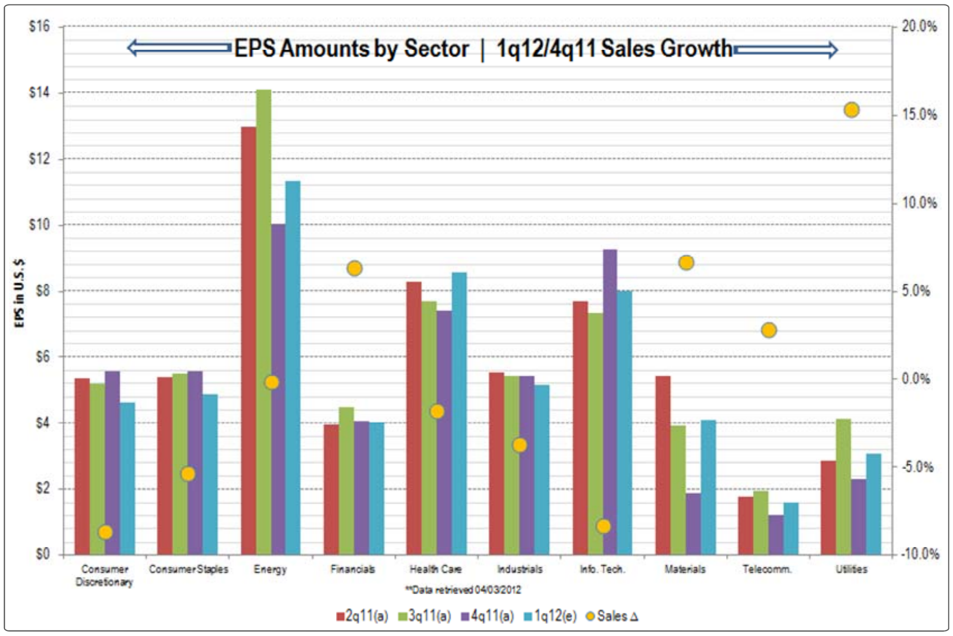
Source: Strateaas Research Partners

Corporate Profit Margins

Thus far, the outsized dose of government stimulus and higher fuel prices has not resulted in much inflation. Indeed, corporate profit margins have almost doubled over this period and U.S. Treasury yields are down approximately 85 basis points (a basis point is 1/100 of 1%) – the exact opposite of what most economists would have predicted. The answer may lay in efficiency gains. Companies and consumers alike have benefitted from the widespread use of productivity enhancing information technology. Companies have also been able to keep wages low by increasing the use of lower cost labor overseas and substituting labor with robotic technology. These efficiency gains have kept inflation at bay and provided a second tailwind for margins: lower borrowing costs. However, there are some signs that these gains may be abating. In the fourth quarter of 2011, unit labor costs rose by 2.8%, which is double the third quarter rate and significantly higher than the fourth quarter gross domestic product (GDP) deflator of 1%. While not yet a sustained trend, the direction of productivity trends will be an important factor under consideration for Congress and the Federal Reserve in the coming months when setting the budget and monetary policy.

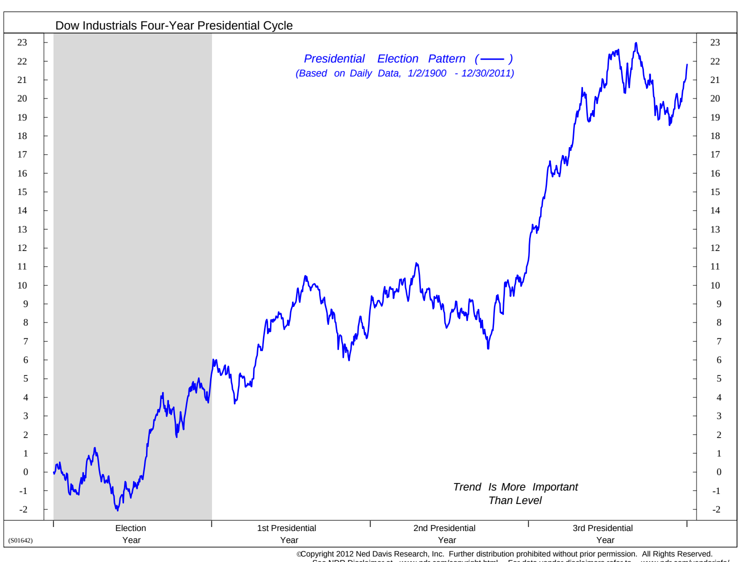
Pronounced Seasonality in the Consumer Staples Sector

The first quarter of the year typically hosts negative sales growth relative to the seasonally strong fourth quarter, especially for cyclical sectors such as Technology, Industrials and Consumer Discretion. One would expect a less seasonal sector such as Consumer Staples to have less variability, but analyst estimates currently project *negative* 5% sales growth for the first quarter of 2012 following *positive* 5% growth in the fourth quarter of 2011. Consumer Staples companies sell non-discretionary items such as food, beverages and household products which are typically purchased with some consistency throughout the year. However, over the last six years this sector has displayed greater seasonal fluctuations than it has in the past. There are a few possible explanations for this trend. First, consumers continue to be sensitive to price and may be "trading down" to lower priced substitutes such as generic cereal. Second, much of the growth in this sector has been from emerging market consumers and these goods are indeed discretionary for someone who only makes $100 – $200 per month. Lastly, a greater percentage of these goods continue to flow through large retailers such as Wal-Mart and Costco who have enormous leverage over their suppliers and can negotiate volume discounts. This is becoming increasingly true in emerging markets where "mom and pop" retailers are losing share to larger branded retailers.



The Presidential Cycle

Among investors, there is a school of thought that equity market returns are dependent upon which year the presidential election falls. The logic behind this theory is that the White House and Congress will implement pro-growth economic policies ahead of the presidential election to ensure that voters are in a good mood by November. Because economic policies take time to benefit the economy and require savings, the second year of the Presidential Cycle is when politicians slow the economy in order to fund economic growth in the 1-2 year period leading up to the election. Over the last 28 election years, the market has been up in 24 of those years. Based on historical results, this theory would imply a 5-6% return this year with the returns weighted towards the second half of the year. However, a closer look at the data shows huge variance in the returns. In fact, some of the worst years of the market have come in election years, most recently in 2008 when the market fell almost 40%. In 1920 the market fell approximately 33%. There are challenges for the market this year that may make it more difficult for this thesis to play out relative to previous years. The record fiscal deficit and a highly polarized Congress make it less likely that the government has much wiggle room, if any, to massage the economy. There is very little clarity as to what will happen to tax rates after the election. Finally, higher gasoline prices may be starting to impact consumer spending patterns and the economy.



IPOs Heating Up

The appetite for Initial Public Offerings (IPOs) appears to be improving with 44 companies going public in the first quarter of 2012 versus 33 in the first quarter of 2011. On average, each company raised $130 million versus $395 million one year ago; however, last year's figure was skewed by five large IPOs. The Technology sector lead the pack with 13 IPOs versus 6 IPOs one year ago, while the energy sector only had one IPO. Considering that the Technology sector returned 22% in the first quarter and the Energy sector returned just 3.4%, the stark difference between the initial public offerings of those sectors is not a surprise. According to Price Waterhouse Coopers, while 80% of IPOs were higher at the end of the quarter, the average IPO return was below its first day average return of 16%. The pipeline of IPOs currently stands at 157 companies and these companies may become public later this year assuming that animal spirits remain in place.

Three months ended March 31, 2012: Value and Volume of US IPOs by Industry
(in $US millions)

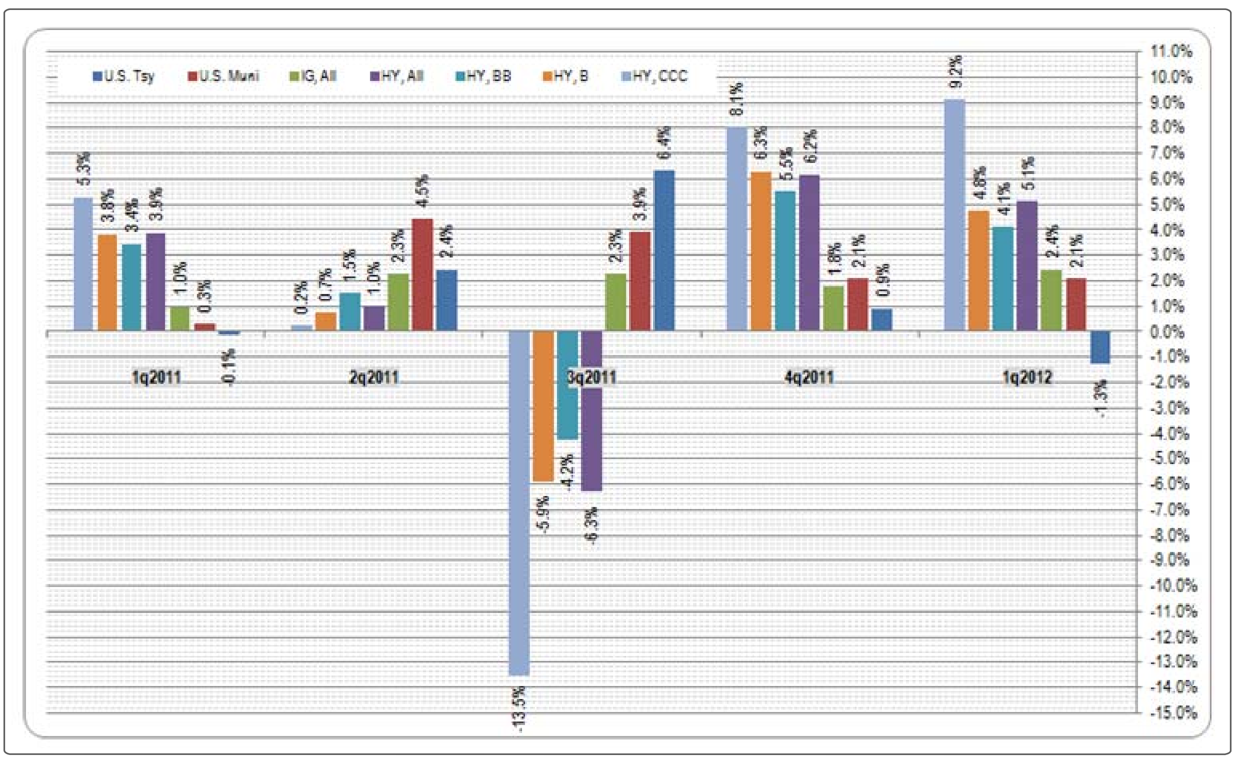
	Q1 2012			Q1 2011		
		Value	Volume		Value	Volume
Industrial	$	2,062.7	9	$	107.3	1
Technology		1,166.9	13		2,380.8	6
Financial Services		955.8	9		1,108.9	11
Business Services		733.5	3		2,033.4	4
Consumer		431.4	5		42.0	1
Healthcare		250.5	4		2,864.0	1
Energy		160.0	1		4,177.3	8
Other		-	-		314.3	1
Total	$	5,760.8	44	$	13,028.0	33

Source: Price Waterhouse Coopers

ECONOMICS AND FIXED INCOME

Fixed Income Market Performance[1]

The pattern of returns for the various quality tranches of fixed income instruments seen in the fourth quarter of 2011 repeated in this past quarter. That is, bonds rated below investment grade had the best return during the quarter, while "risk-free" U.S.



Sources: Bank of America-Merrill Lynch, The Bloomberg

Treasury bonds trailed the group. Two dynamics were likely at work. First, investors' search for yield necessitated accepting credit risk, proxied by credit agency ratings, or duration risk (buying longer maturity bonds in search of higher yields). Second, the macroeconomic outlook and the sentiment towards that outlook improved in the quarter, bolstering tolerance for credit risk. As the chart above indicates, each of the three junk-bond categories, 'BB', 'B' and 'CCC' outperformed the higher-rated categories.

[1] As measured by Bank of America-Merrill Lynch's fixed income indices.

The total return for U.S. Treasury bonds followed fourth quarter 2011's paltry 90 bps (.90%) return with a negative 1.3% return this quarter. Note that the benchmark 10-year U.S. government bond yielded 1.88% when the quarter began, but peaked during this past quarter at 2.4% (price moves inversely to yield). This 52 basis point move is quite large, though the absolute rate level remains quite low. Municipal bondholders fared a bit better, realizing a total return of 2.1%. The segment outperformed Treasury bonds because the risk premium versus Treasurys declined, i.e., spreads-to-Treasurys compressed. In other words, municipal bond investors became more comfortable with the financial conditions of the underlying municipalities.

Comprehensive Capital Analysis and Review (CCAR) Results – Most Banks Pass the Federal Reserve's Stress Test
On March 12th, the Federal Reserve (the Fed) released the results of its 2012 Comprehensive Capital Analysis and Review, otherwise known as the bank stress test. Although the U.S. has several thousand bank-like financial institutions, the stress test only applied to the country's 19 largest banks. Under the "supervisory stress scenario for CCAR 2012", the Fed evaluated lending ability in times of severe economic and financial stress based on capital sufficiency. (The Tier 1 common capital ratio served as the evaluation metric for each institution.) The worst case scenario in the test included a peak unemployment rate of 13%, equity price declines of 50% and home price declines of 21%. JPMorgan Chase, Wells Fargo and U.S. Bancorp were among the 15 large banks that passed the exam. Citigroup did not pass, surprising many. Neither did MetLife, Ally Financial or SunTrust, although MetLife's shortfall caused little concern since a) the company is in the process of selling its retail banking business, thus eliminating its participation in the CCAR, and b) MetLife's primary business is insurance, not banking, and its insurance ratings remain quite strong. Other challenges involving the bank stress test include 1) the absence of a liquidity risk assessment, widely considered a prime contributor to 2008's financial freeze, 2) the single stress path of the assessment and 3) the "black box" nature of the Fed's models since it did not disclose several important underlying assumptions.

The Energy Paradox
While the price of gasoline is a hot topic in the news these days, the dramatic drop of natural gas prices is discussed less often. The blue line in the chart below depicts the rising price of wholesale gasoline prices which recently hit a two-year high. The red line depicts the wholesale price of natural gas which recently hit a two-year low. Unlike previous economic cycles where higher energy prices have short-circuited economic expansions, this cycle has a few unique characteristics to it. First, consumers and

Source: StockCharts.com

businesses are becoming more efficient at using energy due in part to the growing use of information technology and more energy-efficient vehicles. Second, the U.S. and Canada have recently become the largest producers of natural gas thanks to technological advancements in extracting gas from shale formations. These two countries are the global leaders in energy production from shale formations and may have several years of robust production ahead of them. The tremendous supply of this clean natural source of energy is helping North America become the low cost producer of electricity, chemicals and fertilizers. Furthermore, many commercial users of gasoline/diesel are increasingly exploring how to convert their fleets to burn natural gas to take advantage of fuel costs that are 30-50% lower than oil-based fuels. For example, UBS estimates that U.S. Steel Corporation may save up to $200 million dollars per year by switching their energy needs to natural gas. A significant additional benefit is coming in the form of jobs. Pennsylvania, alone, is estimating a 500,000 job benefit from shale gas as infrastructure is built to extract the natural gas and as chemical plants expand manufacturing capacity in the region to take advantage of a low-cost raw material. A longer-term trend to monitor is the impact these prices will have on the global manufacturing supply chain. Because natural gas is very hard to transport, the price around the world varies greatly. While wholesale natural gas is trading at approximately $2.15 per million BTUs (British Thermal Units) in North America, the price in Europe is approximately $11.35 and the price in Japan is $15.90. If

North America retains this wide energy advantage relative to other parts of the world, relocating a greater portion of global manufacturing capacity (and jobs) to this region may make economic sense.

U.S. Treasury Earns a $25 Billion Profit

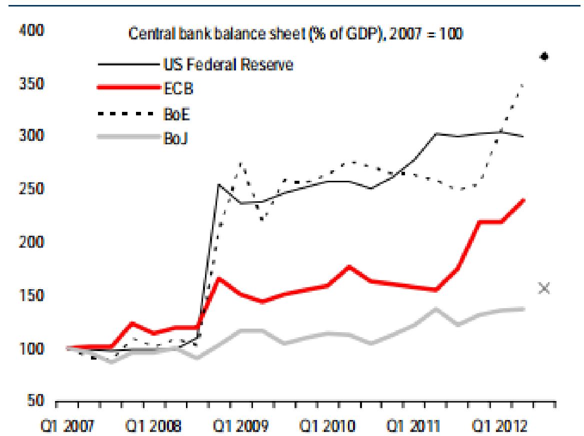
In 2008 and 2009, the U.S. Treasury purchased $225 billion of mortgage-backed securities issued by Fannie Mae (FNMA) and Freddie Mac (FHMC) as part of the U.S. government's response to the Great Recession. The U.S. Treasury, which began unwinding its program in March 2011, recently sold its remaining Great Recession-era Fannie Mae and Freddie Mac bonds, yielding an 11.1% total return to U.S. taxpayers. Although $25 billion is a fair sum of money, any celebration would be premature – forecasts for the total losses related to supporting Fannie and Freddie exceed $100 billion.

Greece Defaulted, Credit Default Swaps Triggered

Perhaps twenty-four months of living with Greece not defaulting provided enough perspective to stop fearing the event. Or, perhaps Greece’s unilateral decision to retroactively insert collective action clauses (CAC) into the sovereign debt it issued under Greek law made a debt swap (and disbursement of €130 billion in bailout money) possible. The new CACs allow Greece to force all bondholders to accept the outcome(s) of less-than-unanimous vote results. Whatever the case, on March 9, Greece's finance ministry reported that 85.8% of those holding bonds issued under Greek law, about 90% of the country's then-outstanding bonds, had voted to acquiesce to a debt swap. Another 10% would "agree" due to the collective action clauses. The terms: principal reductions of 53.5%, below-market coupons and longer maturities. In the end, the principal reductions and lower coupons resulted in losses approaching 75% for private bondholders. The International Swaps and Derivatives Association (ISDA), the governing body for credit default swaps (CDS), quickly decided that Greece's use of the CAC constituted a "credit event", thereby triggering payouts to those who had bought protection against a Greek failure.

Japan: The Other Trillion Dollar Asian Economy

China’s economy, at almost $7 trillion, is the largest economy in Asia and the third largest in the world after the European Union and the United States (source: CIA “The World Factbook”). Rounding out fourth place is Japan at $6 trillion dollars and almost 9% of the global economy. Japan’s economy has faced numerous economic challenges since their real estate and stock market bubble popped almost 32 years ago. The Nikkei 225 stock index is down 75% from its 40,000 peak in 1990. The country has amongst the oldest population in the world because of its exceptionally low birth rates. The Japanese Yen has rallied an unprecedented 60% in the last five years and has subsequently squeezed the profit margins of leading exporters such as Toyota and Sony. Finally, the country suffered a devastating Tsunami and nuclear accident in March of 2011 that resulted in the loss of 16,000 lives and disrupted the lives of millions more. The downward trend in real estate and equity prices resulted in a dramatic shift higher in the savings rate of Japanese citizens. This higher savings rate naturally lowered demand for goods which resulted in lower prices throughout the economy. The more prices fell, the more consumers saved because deferring purchases would usually result in cheaper purchases down the road – a classic case of deflation. As a result, Japanese real GDP has barely grown at 1% per year over the last 30 years. Over this period, the Japanese government has attempted to accelerate the economy by spending enormous sums of money on public projects and financing these projects by running large deficits. While these projects temporarily boosted the economy, the economy never experienced a sustained increase in growth and the inflationary impact of deficits was mitigated by the Japanese citizens themselves – they simply purchased the debt that was issued by the government and increased their saving rate, yet again. In February of 2012, The Bank of Japan (BOJ) – Japan’s central bank – indicated a different stance than in the past. Politicians who have also felt the pain of slow growth are increasingly placing pressure on the BOJ to monetize this Japanese debt and even purchase non-government assets such as stocks and real estate. By debasing their currency, the Japanese are hoping to stop the downward spiral of consumer prices, lower the savings rate, increase consumption and thus, stimulate the economy.



NB: BoJ and BoE include projections to reflect announced, but not yet fully implemented, asset purchase programmes;
Source: national central banks, Credit Suisse research

Source: Credit Suisse, Respective National Banks

COMMENTARY: Caveat Emptor

There are many behavioral hurdles that all of us as human beings face when placing capital at risk in the financial markets. We have often stated that the two biggest risks an investor faces are indigenous to himself or herself: fear and greed. No doubt, it is the latter that has been a major factor behind the investment bubbles and extremes which have occurred since the very first investor committed capital to an investment. While it is often said that "perception is reality", the field of investments and the financial markets definitely contradict that postulate.

Gold experienced an unprecedented rally in the late 1970s through 1980 when it moved from $35 per ounce to nearly $850 per ounce. On an inflation-adjusted basis, gold would have been trading around $2,400 in 1980, so at just over $1,600 per ounce we are still well below that level today.

The Japanese economy and stock market were on a roll in the 1980s. A proliferation of management techniques, seeking to replicate the Japanese style of management that was responsible for such tremendous success, emerged. The Nikkei hit an all time high on December 29, 1989, reaching 38,957.44. Investment dollars had been flowing into the Japanese market and continued to flow into it for a period of time after the peak. Fast forward to March 10, 2009, and the Nikkei reached a 27-year low of 7,054.98, a decline of 82%.

A decade later and closer to home, investors in the late 1990s chased technology stocks, and, as dollars flowed into those stocks, the NASDAQ ran up to a level of 5,132.52 intra-day on March 10, 2000. In the years leading up to that all time high, the “dot.com” stocks were seen as a great way to make money as the “new economy” began to take hold. Less than two years later, on October 10, 2002, the NASDAQ bottomed out at 1,108.49 – a decline of 78%. On March 9, 2009, the most recent low point of the U.S. stock market, the NASDAQ traded at 1,265.52.

Less than a decade later and literally closer to our actual homes, investors chased real estate, even with the idea of "flipping" the homes just a few months after they were purchased. Home prices, led primarily by land values, rose in rapid fashion through 2006 only to suffer significant losses (geographically influenced) through even today. A recent report on home prices indicated prices in some areas are still declining, albeit not as rapidly as a few years ago.

As each bubble was reaching peak levels, the general perception existed that it was a good place and even a prudent place to commit investment capital. For a time, that proved prophetic but reality unfortunately proved to be much different. The reality instead was that when investors commit the greatest amount of capital toward a particular class of investments and take the most amount of risk, it is often when risk is the greatest.

With experiences like this in mind and two major bear markets in the broad U.S. stock market the past 12 years, it is understandable that some investors would look toward a different approach to generating returns in their investment portfolios. Some have turned to hedge funds as evidenced by the dramatic growth in the industry to $2 trillion from just $200 billion 12 years ago. There are more than 10,000 hedge funds worldwide, with the vast majority based in the U.S. and U.K. Barriers to entry are low for hedge fund managers and the rewards, if successful, can be enormous, no doubt also reasons behind the industry growth. Hedge fund managers are some of the most highly compensated in the world. While not of bubble proportions, the hedge fund industry is certainly one segment of the investment marketplace where perception differs from reality. To understand why requires a more in-depth look at the industry.

What are hedge funds? They are private partnerships where the manager has a significant personal stake in the fund. Hedge funds are generally organized as limited partnerships or limited liability companies, many times domiciled off shore for tax reasons. They are not regulated and are free to invest in a number of strategies including those utilizing leverage and derivatives. Their investment strategy can be very narrow and concentrated or very broad, including stocks, bonds, currencies, derivatives and just about any other type of financial asset. Investors usually pay an annual management fee of 2% and a performance fee of 20% of any gains achieved by the portfolio. If a hedge fund should experience a negative return, the portfolio’s “high water mark” has to be exceeded in order for the manager to receive another performance fee, but in the mean time they still collect the annual management fee. Hedge fund investors usually have a lockup period of several years in which investors are not allowed to withdraw money from the fund, so investments can be illiquid.

Originally, hedge funds were set up to hedge against market risk. The early hedge fund managers would buy perceived undervalued assets and sell short an equal amount of perceived overvalued assets thus creating a market neutral portfolio not affected by market conditions. Since the first hedge fund was formed in 1949 by Alfred Winslow Jones, hedge funds have adopted a multitude of strategies. Very few remain market neutral as can be attested to by the many hedge fund investors who lost significant sums of money in 2008. Instead, many such managers still take long and short, but unequal, positions in stocks.

How do hedge fund investors fare? There is not complete transparency as hedge funds have not been required to report returns. Additionally, hedge funds tend to go out of existence over a period of time. More than 3,500 hedge funds have terminated operations worldwide since 2007, only to be replaced by new ones. The industry is dominated by 100 or so hedge funds, and the thousands of others don't amount to much in terms of impact or creating wealth for investors. A recent book by Simon Lack reports that hedge fund investors, after fees, earned only 2.1% annually since 1998, less than what they could have earned investing in Treasury bills or bonds with the added detriment of accepting significantly more risk (i.e., 2008 losses). Further, it appears that fund performance was better in the earlier part of the period when the hedge fund industry was significantly smaller.

How do the hedge fund managers fare? Mr. Lack estimates that hedge funds made gains of $449 billion before performance fees from 1998-2010 and $70 billion after fees. So $379 billion or 84% of gains were paid out to mangers leaving only $70 billion for investors. And more recently, most hedge fund investors have not recouped their hedge fund losses from 2008 which may have wiped out their previous gains. Mr. Lack points out that even though most hedge fund investors are still "under water", the hedge fund managers have taken out more than $100 billion in fees since then. Even if a hedge fund manager achieves several years of good returns, there is no predictive basis for future success. This was the recent experience of John Paulson, whose "The Advantage Plus" hedge fund had positive returns in 2008, 2009 and 2010 prior to suffering a loss of over 50% in 2011. (As a manager, Paulson made $4.9 billion in 2010!) This was also the case with Long-Term Capital Management.

While the basis for hedging a portfolio is to manage risk, doing so by using hedge funds themselves can obviously present its challenges. Once successful and large, hedge fund managers usually shut the fund to new investors. In some cases, they have returned client money and focus solely on managing their own money. At Wallington Asset Management, it is our preference to manage risk in a different manner, one that has proven successful long-term. It is our belief that managing risk on the basis of pre-determined asset allocation benchmarks along with efficient diversification within asset classes provides a more appropriate foundation for successful investing. We also believe that a "2 & 20" fee structure is simply not appropriate.

"Stock market bubbles don't grow out of thin air. They have a solid basis in reality, but reality as distorted by a misconception."
– George Soros

April, 2012