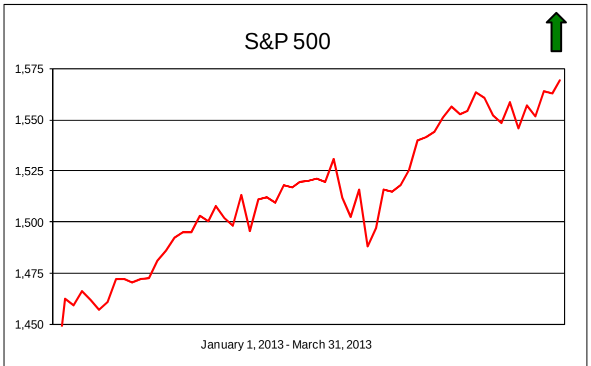
Wallington ASSET MANAGEMENT

INDEPENDENT INVESTMENT COUNSEL

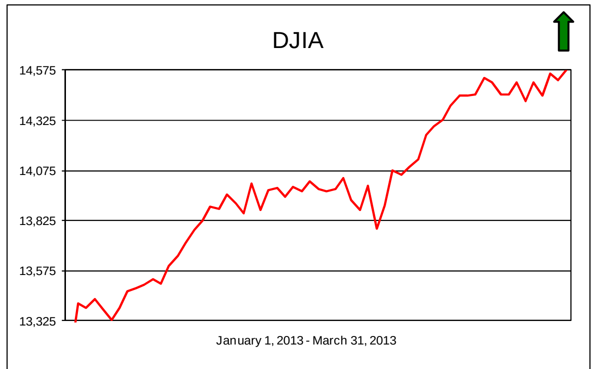
QUARTERLY REVIEW ***97th Edition*** ***2013: First Quarter***

CAPITAL MARKETS SCOREBOARD

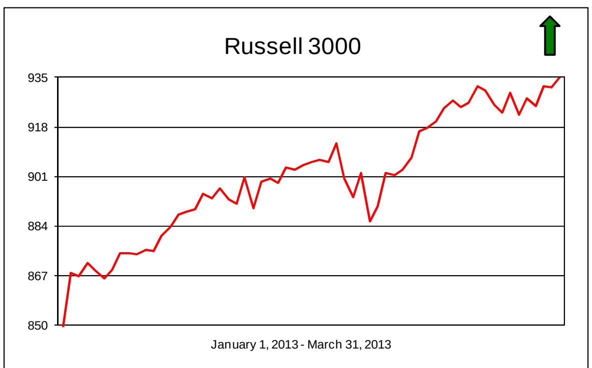
January 1, 2013 – March 31, 2013



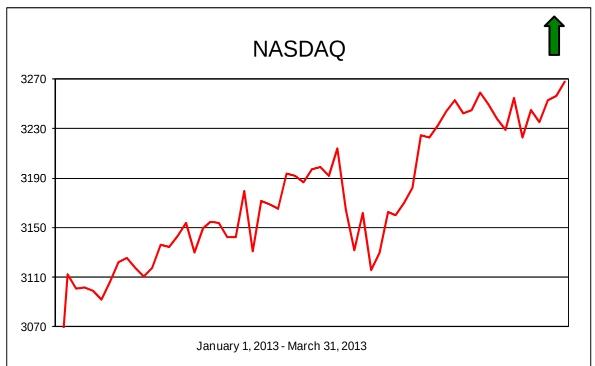
1st Qtr 10.6% YTD 10.6%



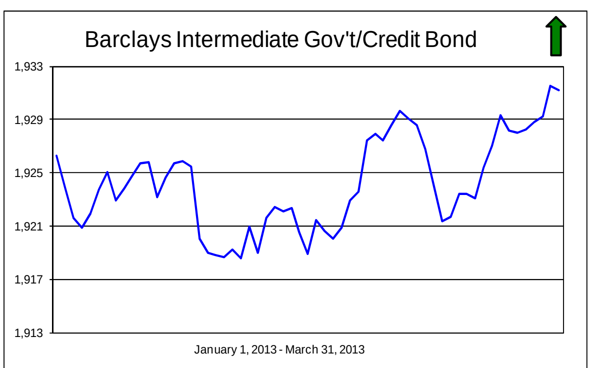
1st Qtr 11.9% YTD 11.9%



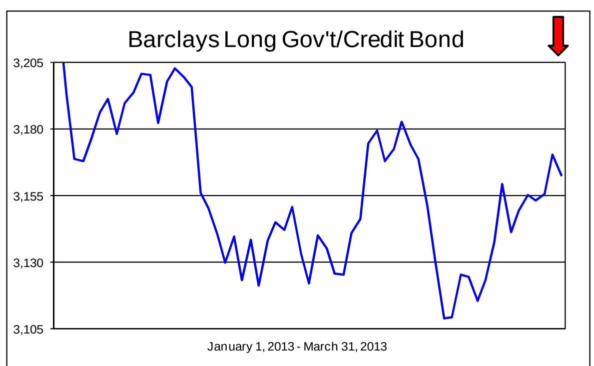
1st Qtr 11.1% YTD 11.1%



1st Qtr 8.5% YTD 8.5%



1st Qtr 0.3% YTD 0.3%



1st Qtr -2.0% YTD -2.0%

Performance Numbers Reflect Total Returns

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EQUITIES

Equity Market Performance

The U.S. stock market continued to move higher in the first quarter of 2013, leading the Standard & Poor's 500 Index (S&P 500) to a new all-time closing high of 1,569.19. Six of the ten economic sectors comprising the S&P 500 posted double-digit gains in the quarter, led by Health Care at 15.2% and Consumer Staples at 13.8%. The Utilities and Consumer Discretion sectors tied for third with 11.8% gains, while Financials and Industrials returned 10.9% and 10.1%, respectively.

S&P 500 by GICS Sector	Price Return (%)	
	1Q13	**2012**
Financials	10.9	26.3
Consumer Discretion	11.8	21.9
Health Care	15.2	15.2
Information Technology	4.3	13.2
Telecommunications	8.2	12.5
Industrials	10.1	12.5
Materials	4.2	12.2
Consumer Staples	13.8	7.5
Energy	9.6	2.3
Utilities	11.8	-2.9
S&P 500 Index	**10.0**	**13.4**

The S&P 500's full recovery occurred four years to the month after bottoming in early March of 2009. In the interim, aggregate stock prices have vacillated largely due to macroeconomic events such as Europe's ongoing financial crisis and U.S. politics. Two of the most definitive events that helped sustain the rebound: 1) Federal Reserve Chairman Ben Bernanke's August 2010 "QE2" speech at the central bank's annual Economic Policy Symposium in Jackson Hole, WY and 2) European Central Bank (ECB) President Mario Draghi's July 2012 declaration that the ECB would do "whatever it takes" to save the European Union's common currency, the Euro (€).

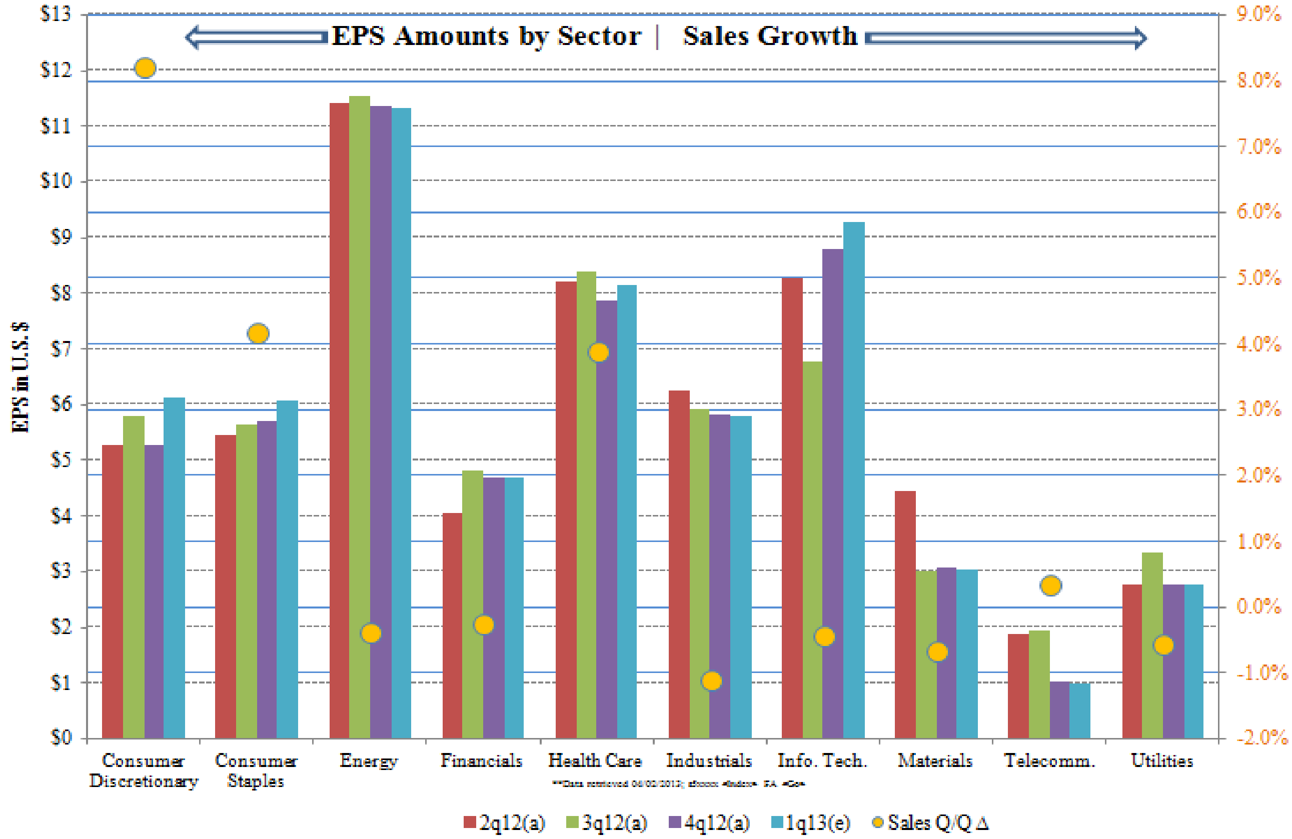
Like the S&P 500, the Dow Jones Industrial Average (DJIA) and the Russell 3000 (RUAZ) quarter-end values were at all-time highs, although the latter two indices had previously surpassed their pre-crisis highs during the first quarter of the year. The Nasdaq Composite's 3,268 reading at quarter-end remains well short of its all-time, dot-com bubble high of 5,133.

S&P 500 Pricing Since March 2008 with Major Macro Events Noted

Source: Strategas Research Partners

Earnings Review and Outlook

During the first quarter of 2013, the members of the S&P 500 reported results for the fourth quarter of 2012. S&P Dow Jones Indices' Senior Index Analyst Howard Silverblatt compiled the following regarding those reports: 64.7% of companies exceeded expectations, 24.9% fell short of expectations and 10.4% met earnings expectations.



Source: Wallington Asset Management, Bloomberg Professional Service

In aggregate, the companies' sales grew 6.9% year-over-year (y/y) and 4.9% sequentially. Earnings for the index in the quarter equaled $25.10, which was 8.0% higher y/y but just 0.6% higher quarter-over-quarter (q/q).

For the first quarter of 2013, as the bar chart above illustrates, six of the ten economic sectors for the S&P 500 are forecasted to report negative quarterly sales growth (see orange dot), while five are expected to post earnings at or below the levels reported in the fourth quarter of 2012. Factset's "Earnings Insight" dated March 22, 2013 indicated that first quarter projected earnings for the aggregate of S&P 500 companies will be 0.7% lower than what was posted in the first quarter of 2012. In addition, 84 companies had issued negative EPS guidance for first quarter at that point, while 24 had issued positive guidance. Finally, earnings estimates for the second quarter of 2013 also point toward anemic growth, while estimates for the second half of 2013 and all of 2014 are robust.

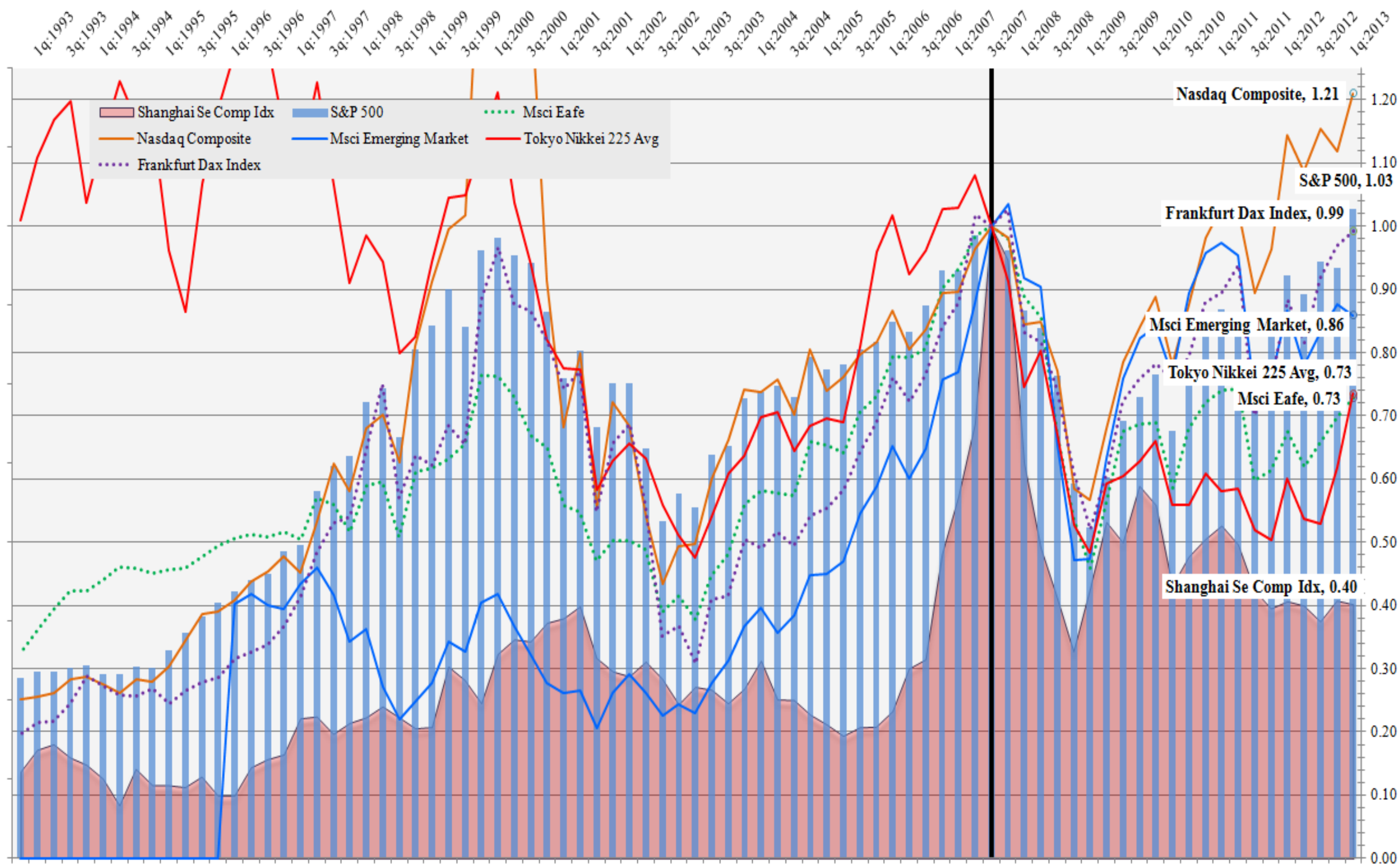
Have Average Equity Holding Periods Declined?

Three academicians recently argued[1] that the much-maligned long-term decline of average equity holding periods is based on a faulty measure. The authors illustrate how standard, turnover-based holding period calculations have been "strongly affected by the recent increase in High Frequency Trading [HFT]." HFT is computer-generated trading which uses complex algorithms to trade at rapid speeds with very short holding periods. On the other hand, the authors' preferred holding period measure is not affected by rapid-fire trading because it measures the dollar-weighted average holding period of institutional investors based on quarterly holdings reports filed with the U.S. Securities and Exchange Commission. Importantly, institutional investors control more than 70% of investable funds in the U.S. So, instead of concluding that the average holding period has declined from eight *years* in the

[1] Martijn Cremers, Ankur Pareek, and Zacharias Sautner; December 17, 2012; "Stock Duration and Misvaluation"

1960s to five *days* today, the authors indicate that the holding period for institutional investors *rose* from 1.2 years in 1985 to 1.5 years in 2010.

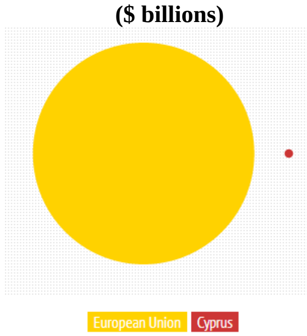
U.S. Markets Outpace Global Markets



Source: Wallington Asset Management, Thomson Reuters' Baseline

Despite fears surrounding the U.S. Fiscal Cliff and U.S. Budget Sequester, U.S. equities significantly outperformed foreign developed and emerging markets in the first three months of 2013 as investors flocked to the safe haven of the U.S. dollar. As noted, the DJIA reached a new high after rising 11.3% (excluding dividends), its best first quarter in 15 years. The S&P 500 rose 10% (excluding dividends), surpassing its previous record high of 1,565.15 (2007), while Chinese wealth-management restrictions and continued uncertainty around the Euro spurred the largest first-quarter decline in emerging market stocks in five years. The MSCI Emerging Markets Index fell 3.6%, while the MSCI Europe, Australasia and Far East Index (EAFE), which tracks developed markets outside of the U.S. and Canada, posted a 3.7% first-quarter return. Emerging market performance could turn positive, as attractive valuations have resulted in significant inflows to mutual and exchange-traded funds.

Cyprus GDP v. EU GDP
($ billions)



Source: CIA World Factbook, Motleyfool.com; infogr.am

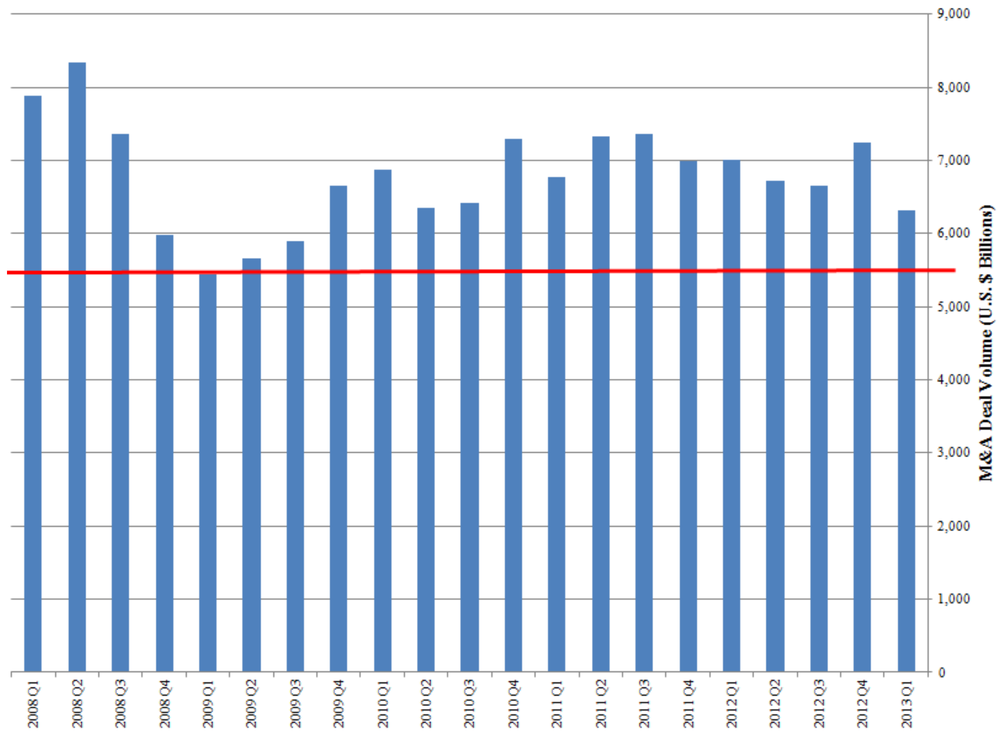
Cyprus – A Brief Recap

Prior to the latest worldwide financial crisis, Cyprus intentionally targeted becoming an offshore financial center. It succeeded, eventually attracting deposits approximately eight times as large as its 2010 GDP of €18 - €20 billion. The country's banks sourced about one-half of their deposits from foreigners, including what some estimate as 25% from wealthy Russians. Cyprus banks often chose to purchase sovereign bonds of Greece with the deposits, so the European Union (EU) led bailout that imposed principal reductions reaching 50% on holders of Greek debt crippled Cyprus' major domestic banks. Cyprus finally requested intervention from the European Financial Stability Facility or the European Stability Mechanism in mid-2012. The country and the Troika, consisting of the European Commission

(EC), the International Monetary Fund (IMF) and the European Central Bank (ECB), agreed to terms on November 30, 2012 but still needed to agree on the amount of money required to bail out the country. In mid-March 2013, the parties agreed to a sum of €10 billion, including a one-time bank deposit levy of 6.7% for deposits less than €100,000 and 9.9% for deposits above that threshold. According to the agreement, the depositors would have received equity in their bank in return for the levy. Fortunately, the final agreement did not include any type of bank levy.

Mergers & Acquisitions

After an above-average end to deal activity in 2012, corporate takeover activity slowed drastically at the start of 2013 from both a volume and dollar value perspective. While deals are in motion for household names such as Dell Inc., H.J. Heinz Co. and NBCUniversal, the level of mergers and acquisitions was below average during the quarter. These three deals have accounted for more than 40% of deal volume year-to-date, averaging over $20 billion each. Smaller deals of less than $1 billion were rare, accounting for their smallest percentage of quarterly deal volume since 2007. The environment remains ripe for acceleration in activity in the near future. Corporations and private equity firms continue to maintain large cash hoards. Debt also remains cheap, which could facilitate an increase in leveraged buyouts. While market values of many companies have increased significantly since March 2009, this has not traditionally been a detriment to takeover activity since it also correlates with strength of the acquirer. North America was the only region to record an increase in mergers and acquisitions as a plurality of the deals involved North American-based companies. Indeed, China's $26 billion in announced deals were the lowest since 2009. European macro-economic issues continue to create roadblocks in healing CEO confidence, while Asia has suffered from slowing growth prospects.



Source: Wallington Asset Management, Bloomberg Professional Service

ECONOMICS AND FIXED INCOME

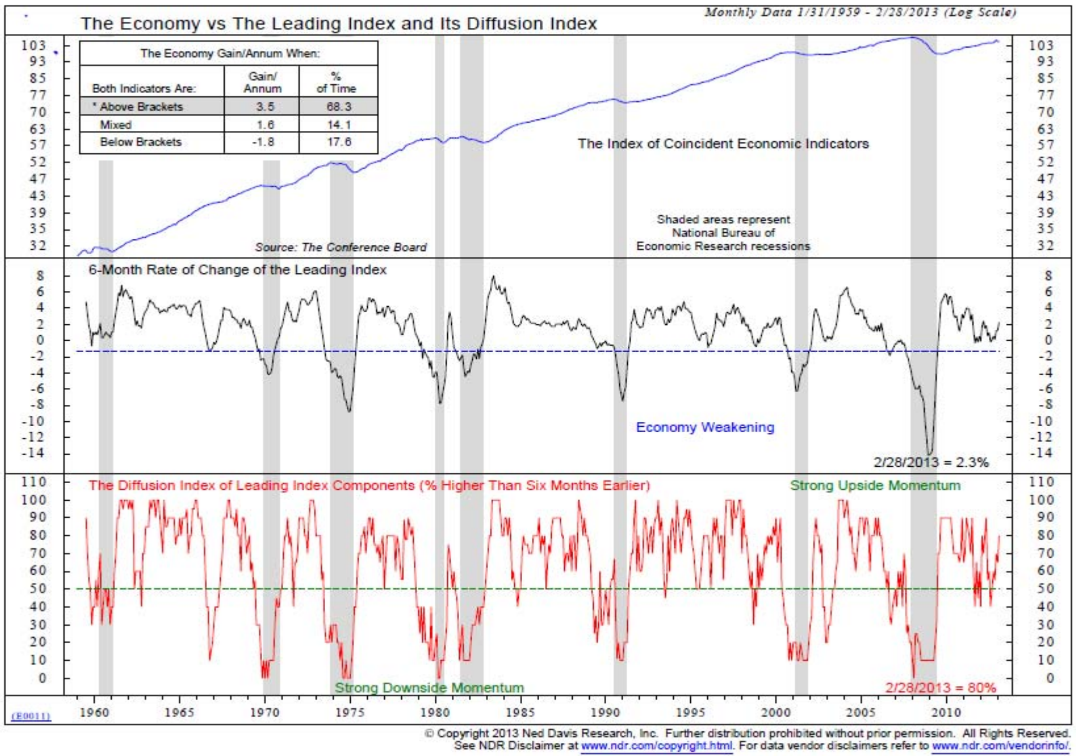
Fixed Income Market Performance

According to Bank of America/Merrill Lynch's suite of fixed income indices, the investment grade corporate bond index inched up 0.05% in the quarter. Corporate bonds outperformed U.S. Treasury (UST) bonds, which declined 0.26%. The municipal bond index rose 0.58%, hindered by its 0.5% drop in March. Debt considered less than investment grade, known as high-yield debt with ratings from BB+ through CCC-, posted the best returns in the fixed income sector, 2.90%. While high-yield bonds should provide higher returns due to their higher risk orientation, their outperformance recently is no doubt partially indicative of a yield chase mentality due to the low interest rate environment created by the Fed.

Economic Indicators

Real Gross Domestic Product (GDP) in the fourth quarter of 2012 was originally reported to have increased 0.1% but was revised upward to 0.4%. This revision was slightly below the consensus estimate of 0.5%. Real growth was subdued at year-end, largely due to a 22.1% drop in government defense spending, no doubt in anticipation of the U.S. Sequester. Current estimates for GDP growth for the first quarter of 2013 are 3.5% and 1.9% for the entire year.

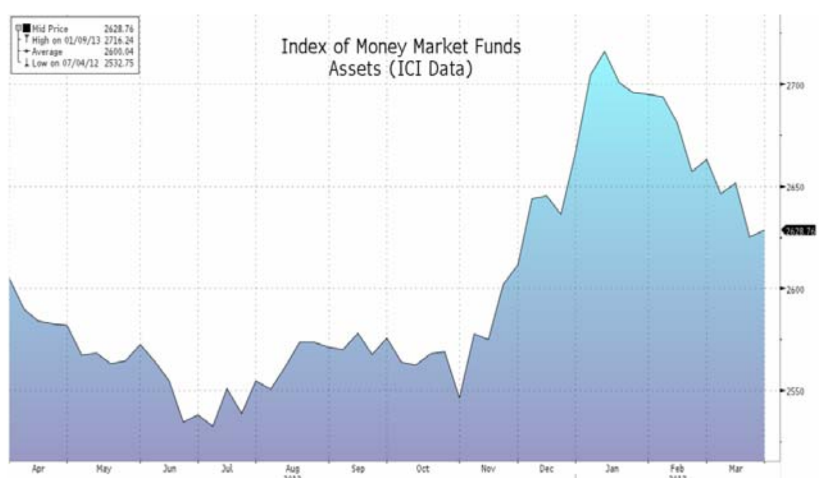
The Conference Board's Leading Economic Index (LEI) rose 0.5% in February, its fifth increase in the past six months, matching economists' expectations. Eight of the ten components in the index made positive contributions, led by the interest rate spread and building permits. Over the past six months, the LEI increased 2.3%, and the strength among individual indicators has grown more widespread. This is historically consistent with continued long-term, trend-like economic growth. Although federal spending cuts present a headwind to growth this year, the Conference Board noted "the expansion in economic activity should continue, albeit at a slow to moderate pace." On a y/y basis, the LEI was up 2.0%, below the long-term average gain of 2.2% per annum since 1949.



Source: Ned Davis Research, Inc.

Mutual Fund Flows

Cash flows into mutual funds shifted somewhat during the first three months of 2013. Equity mutual funds experienced positive net cash inflows for the first time on a monthly basis since February 2012, and on a quarterly basis since the first quarter of 2011. While many strategists thought the source of the inflows would be from bond mutual fund redemptions in a shift deemed "The Great Rotation," this phenomenon has not yet occurred. Instead, money market fund balances have decreased steadily

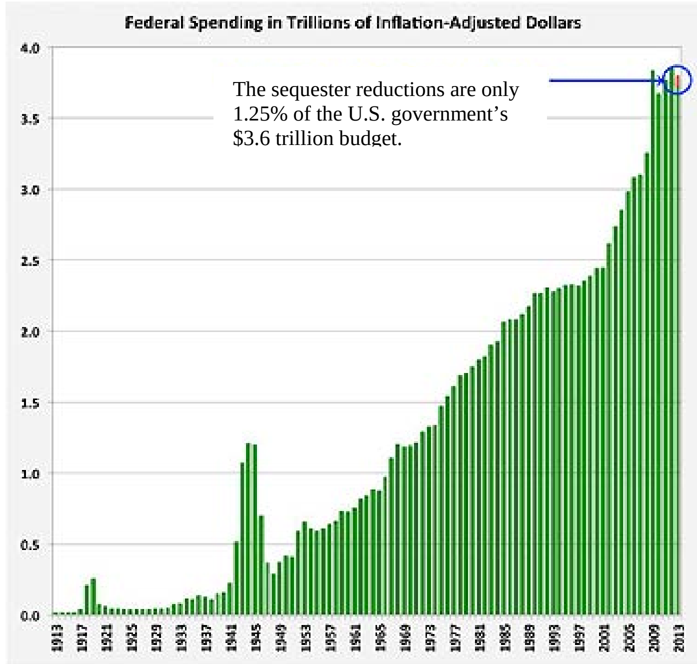


Source: Bloomberg Professional Service

over the course of 2013. This is partially the result of a surge in money fund balances at the end of 2012 caused by fiscal cliff concerns and capital gains realization. Cash continues to flow into fixed income funds, as it has on a monthly basis since August 2011. Contrary to the theory of "The Great Rotation," q/q flows into fixed income funds have actually increased. This continued demand has maintained support for bond prices, with the 10-year UST yield finishing the quarter under 1.9%.

U.S. Budget Sequester

In August 2011, The Budget Control Act (BCA) was passed which contained a package of automatic spending cuts (aka Sequester) initially put forth by the Obama administration. The total of the projected cuts from 2013 through 2021 is $1.2 trillion and they are to be evenly split between defense spending and discretionary domestic spending, which exempts most spending on entitlements like Social Security and Medicaid. The U.S. Sequester was to be triggered only if a formal agreement on specific budget cuts could not be passed. The deadline for this agreement was extended until February 28, 2013, a date which passed without reaching an agreement.

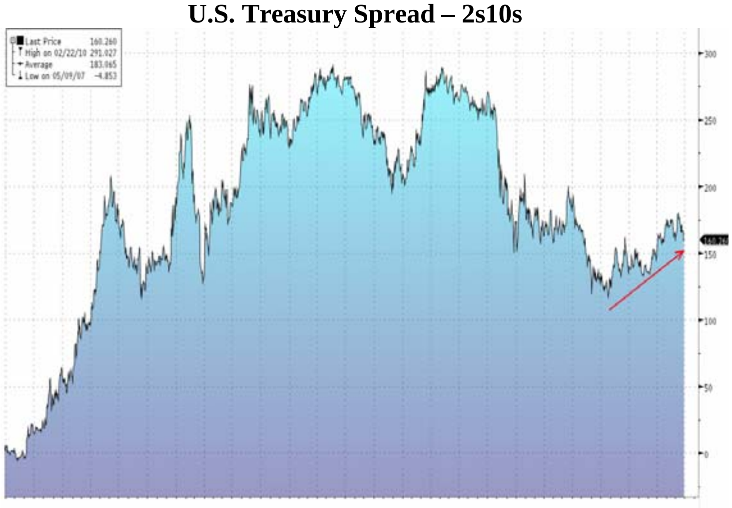


Source: Wallington Asset Management; http://townhall.com/tipsheet/carolplattliebau/2013/02/27/explaining-the-sequester-n1522004

In 2013, the $85 billion spending cut actually relates to budget authority, not budget outlays. According to the Congressional Budget Office (CBO), budget outlays will decrease by $44 billion, or one-quarter of one percent of GDP (GDP is $15.8 trillion). Also, the $44 billion outlay reduction is only 1.25% of the $3.6 trillion government budget. Additionally, the President has administrative authority to determine how to allocate a significant amount of those reductions. In most cases, any cuts would be relative to a rising budget baseline. So, the U.S. Sequester only slows the *growth* of spending instead of actually reducing the level of spending. For reference, Federal outlays as a share of GDP peaked at 25.2% in 2009, fell to 24.1% in 2011, and came in at 22.8% in 2012. Even though some progress has been made, the long-term historical norm is about 19%, so spending is still too high especially when considering U.S. debt levels.

Yield Curve – Steeper

U.S. Treasury Spread – 2s10s

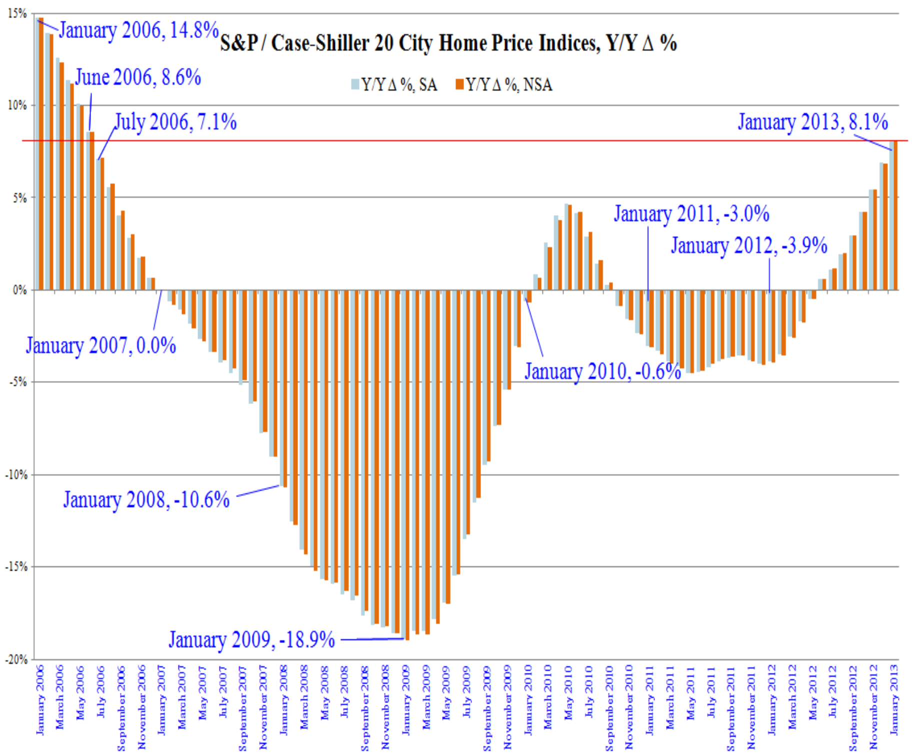


Source: Wallington Asset Management, Bloomberg Professional Service

The yield curve has steepened over the last nine months which some market watchers view as an indicator of economic strength. The yield curve measures the difference in yield between UST securities of different maturities. One comparison often used is the difference in yield between the 10-year note and the 2-year note. Since banks earn income by capturing the difference between short-term rates and longer-term rates, i.e., banks lend longer-term and borrow short-term, a steeper 2s10s generally entices banks to increase their loan volumes. This increased appetite for lending, especially to businesses, typically starts the virtuous cycle of investing and hiring. Likewise, if the 10-year yield is falling faster than the 2-year yield, known as a flattening yield curve, banks' spread income declines and lending standards rise, which should reduce the benefit of or even reverse the aforementioned virtuous cycle. In particular, every recession since at least 1976 has been preceded by a negative spread value, i.e., the yield on the 2-year UST note exceeds the yield on the 10-year UST note.

Spreads in yields are often quoted in basis points (bps). One basis point equals 0.01% so 100bps is equivalent to 1%. While the yield curve steepened from 120 (bps) in June 2012 to 160 bps by March 2013, it is important to note that economic activity still remains lackluster. One key reason may be the higher regulatory burden on banks relative to previous cycles. Also, while the yield curve has indeed steepened, the spread is not as enticing for banks to lend as it was in 2009 and 2010 when it nearly reached 300 bps. Ironically, a key reason that the yield curve has not steepened further is the Fed's large scale purchases of UST securities driving down yields on longer maturity bonds.

Home Prices on the Rise



Source: Wallington Asset Management, S&P/Case-Shiller 20 City Home Price Index data

Home prices recorded their biggest y/y gain since 2006 according to the S&P / Case-Shiller home price index of the largest 20 markets. Home prices rose 8.1% in January of this year, the first January increase since the 14.8% increase logged in January of 2006, the year prior to the bursting of the housing bubble. Additionally, the National Association of Realtors® reported February's existing home sales, which is comprised of completed transactions involving single-family homes, townhomes, condominiums and co-ops, were at the highest level since the tax credit period of November 2009. A number of factors have aided the recovery lately including a reduced inventory of homes available for sale, mortgage rates that remain near record lows and a reduction of homes in foreclosure. Even with the recovery, by some estimates, home prices are still 34% under their 2006 peak and home ownership as a percentage of the population is still around 65%, the lowest level since 1997. Responding to the higher number of renters, many private equity firms are voraciously buying single-family home foreclosure properties to add to the rental pool. Scott Simon, head of mortgage bonds at Pimco, indicates about six million borrowers will lose their homes in the next five years, creating demand for as many as four million new rental homes.

COMMENTARY: A Change of Paradigm for Fixed Income Investors

There has been considerable concern recently about a perceived "bubble" in the fixed income (bond) markets. Interest rates have been in a secular decline since 1982, when long-term U.S. Treasury bonds approached 16% and short-term interest rates 20% – some of the highest rates in U.S. history. Interest rates declined for the next 25 years and reached what would be considered normal levels by 2007. Then, in response to the financial crisis and subsequent recession in the U.S. and Europe, the Fed and European Central Bank took interest rates to historic lows. The customary monetary tool to spur economic growth, reducing short-term interest rates, was started by the Fed in September 2007 and maintained until rates approached zero in December 2008. It was a very aggressive move by the Fed, but it was insufficient to bring the economy back to its historically normal level of growth. There was plenty of liquidity in the system, but there was a lack of confidence by consumers to spend, corporations to invest and banks to lend.

The Fed started a Quantitative Easing (QE) program in 2008 which entailed purchasing U.S. Treasury bonds and mortgage-backed securities. There have been QE1, QE2 and QE3; the latter of which is still in effect. To date, the Fed has purchased more than $2 trillion of bonds. The goal of the QE programs has been to lower long-term interest rates and create confidence through the wealth effect by increasing housing, stock and bond prices. Another goal has been to increase inflationary expectations such that the economy would not fall into a deflationary spiral as experienced in Japan.

The QE programs have resulted in higher home prices, higher stock prices and lower long-term interest rates (higher bond prices). Most bonds in the U.S. are priced relative to U.S. Treasury securities, such as the 10-year note, which reached a low of nearly 1.4% in 2012. With short-term rates close to zero, many investors, especially those with an income need have had few choices but to chase yields by taking on more risk. That risk primarily involves interest rate risk by investing in bonds with longer maturities and credit risk by investing in bonds of lower quality. As a result, since 2007, $1.4 trillion has been invested in bond mutual funds and exchange-traded funds. Over the same period, about $1.3 trillion has been withdrawn from money market funds and $500 billion from equity mutual funds. Counting direct purchases and sales of bonds and the investment activity of other institutions like pension funds, the dollar flows into bonds were much larger. The supply of bonds has also grown dramatically; the U.S. government alone issued more than $5 trillion of bonds over the last five years, although the Fed purchased much of that debt. Corporations have also been issuing record amounts of debt (bonds) whether they need the money or not; some are just taking advantage of the lower interest rates. A particular worry is the massive amount of high-yield (junk) bonds issued by corporations with less than investment grade bond ratings. With the low/zero rate monetary policy, the Fed may have motivated excessive risk taking, possibly to "bubble" proportions, in fixed income securities.

Only time will tell if bonds have indeed reached "bubble" proportions. Regardless, investors should be highly cognizant of the risks to which they are exposing their capital when investing in fixed income instruments today. Should long-term interest rates for U.S. Treasury bonds increase even by a relatively modest amount, investors who have stretched for yield by investing in long-term bonds could find the additional yield more than offset by price declines. A longer-duration bond is much more volatile in price than a shorter duration bond for a given change in interest rates, *ceteris paribus*. Prudent fixed income investors should thus be certain the duration of their fixed income portfolios are not extended too far in search of yield. The other major risk facing bond investors today is credit risk, i.e. how able is a bond issuer to make periodic interest payments and return principle at maturity to bond investors holding the issuer's debt. Investors in high-yield bonds require more compensation for assuming additional credit risk than investors holding investment grade bonds. The spread between high-yield debt and investment grade debt has narrowed appreciably and is now at a level where many strategists are concerned the holders of junk bonds are not being compensated adequately for the credit risk they have assumed in their portfolio.

In spite of the above-mentioned risks, bonds remain a worthwhile investment for certain investors. While there is a fairly high probability the Fed will "take away the punch bowl" at some point and cause problems for bond investors who have not prudently managed risk, a well-managed bond portfolio continues to serve as a volatility hedge to securities offering higher potential returns such as equities. Further, an increase in interest rates may not be imminent since the economy is growing in a pedestrian fashion even at this low level of interest rates. Bond investors should not, however, expect returns to be near the levels they have become accustomed to in recent years.

Investing in bonds to primarily manage volatility with the expectation of generating modest returns is a paradigm shift bond investors would be wise to make if they have not done so already. Not making this shift would surely lead to frustration and a propensity to expose their portfolios to more risk than they otherwise would deem as acceptable, a situation which often results in making untimely decisions after the damage has already been done.

April 2013

*"An investment in knowledge pays the best interest." – **Benjamin Franklin***