



Philosophy

Fort Washington believes in using a broad range of fixed income strategies in Active and Core Fixed Income. We believe that tactical efficient allocation of risk among these strategies provides the best opportunity to outperform. Additional value can be created by effective execution of these themes by our highly specialized sector managers.

Process

Fort Washington employs a disciplined investment process designed to maximize risk-adjusted returns. Careful examination of the fixed income markets helps us uncover relative value opportunities over the short-term in a variety of fixed income strategies and, through the use of a risk budget, determine our investment themes. These themes include duration management, sector allocation, and yield curve positioning. Once determined, our dedicated sector specialists evaluate the relative opportunities in each of these strategies to select specific securities and effectively execute the investment themes.

Investment Professionals

Timothy J. Policinski, CFA
Senior Portfolio Manager
32 Years Experience

Asset Specialists

Daniel J. Carter, CFA
U.S. Treasury/Agency/Emerging
Markets Debt

Rance G. Duke, JD
Investment-grade Corporate/Emerging
Markets Debt

Roger M. Lanham, CFA
Investment-grade Corporate

Howard R. Lodge, PhD
Commerical Mortgage-backed/Derivatives

Brent A. Miller, CFA
Mortgage-backed

Scott D. Weston
Mortgage-backed

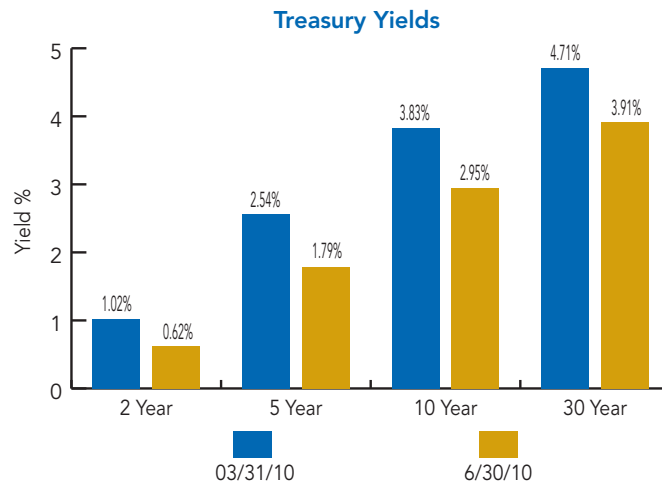
Brendan M. White, CFA
High Yield

Performance

The bond market, as represented by the Barclays Capital U.S. Aggregate Index, returned 3.49% in the second quarter, bringing the year to date return to 5.33%. Fort Washington's Active and Core Fixed Income composites underperformed the index in the quarter, driven by the sharp decline in interest rates and widening risk premiums in the wake of financial difficulties in the Eurozone. Non-government sectors of the bond market that had been performing well in 2010 reversed course in the second quarter as the troubles in Europe increased concern that the U.S. economy will be negatively impacted.

Factors Contributing to Performance

Interest rates declined during the quarter, with long-term yields declining faster than short-term. Economic data has been solid, although recently has showed some moderation. The Federal Reserve, which had been expected to raise interest rates in late 2010/early 2011, is now likely to be on hold into mid-2011. Recent inflation reports have been low, which also contributed to declining interest rates. We are structuring portfolios with slightly less interest rate risk than the benchmark. We believe higher interest rates are likely over the medium-term, but in the near-term will likely remain relatively low.



Source: Bloomberg

The Treasury Inflation Protected Securities (TIPS) market under-performed during the quarter, which was a slight negative for performance. Lower than expected inflation data as well as lingering concerns over disinflationary forces in the economy led to a decline in inflation expectations. We decreased the weighting to TIPS in the quarter as a result of these factors.

The corporate bond market underperformed in the quarter. Portfolios were overweight this sector, which was a negative for performance. While economic growth is showing some signs of moderation, the fundamentals for corporate bonds remain solid and we believe this sector will perform well relative to Treasuries. Commercial mortgage-backed securities (CMBS) have performed well relative to Treasuries for the year, even with recent underperformance in the quarter. Portfolios are slightly overweight this sector, which has been a positive for performance.

In portfolios where High Yield is allowable, the allocation to High Yield was a negative for performance. The High Yield market, represented by the Merrill Lynch High Yield Cash Pay Index, returned -.01% for the quarter.

General Economic and Market Outlook

With results for the second quarter now in, there has been a pronounced shift in sentiment among investors about the prospects for the global economy. Until late April, market participants were hopeful that the U.S. and international economies were on the path to a self-sustaining recovery. More recently, however, problems in euro-zone have spawned talk of a "double-dip" in Europe, and investors have become concerned about a possible weakening in China. At the same time, the job picture in the United States turned less favorable in May, and recent economic data point to a slowdown ahead.

Amid these developments, there has been a significant re-pricing of market risks. U.S. and international equity markets have fallen by 15% -20% from their recent highs. In the U.S. bond market, long-term treasury yields have fallen by a full percentage point from their levels in early April. In Europe, sovereign spreads versus German government bonds have widened, while the euro has weakened considerably.

In our judgment, the problems in Europe and uncertainty about fiscal and regulatory policies in the United States are likely to contribute to softer growth in the industrial countries. That said, we continue to believe the risk of a “double dip” is low in the United States and Asia.

We share investors’ concerns about Europe, mainly because the debt crisis in Greece has morphed into a problem for other southern European countries and European banks. Nor do we see a quick resolution to the crisis. Policymakers effectively have created a European version of TARP to buy time for the problem countries to bring their fiscal houses in order. However, the policy actions have not convinced investors that Greece, and possibly Portugal and Spain, will be able to avoid debt rescheduling. Furthermore, European banks have experienced funding problems, which have required the European Central Bank to infuse added liquidity. It remains to be seen whether the announcement of “stress test” results for European banks in mid-July will have a calming effect.

By comparison, we view conditions in China and Emerging Asia more favorably. While economic activity in China and the Far East appears to be moderating, the region should continue to be the leading engine of world recovery. In our view, the Chinese authorities are prudent in tightening monetary policy to counter a potential property bubble and incipient inflation pressures. They also have responded to growing international pressure by allowing the Chinese currency to appreciate gradually. While growth in China is poised to downshift from double digit rates, we do not foresee a precipitous slowdown that would jeopardize economic expansion in the region.

The U.S. economy continues to perform between Europe and Asia, with real GDP growth estimated to have expanded at a 3% rate in the first half of this year. This constitutes a sub-par recovery, given the severity of the recession in 2008-09 and the persistence of high unemployment. The bright spot is the corporate sector, where profits have risen significantly, as margins have improved and top-line revenue growth has begun to expand. Thus far, however, businesses are adding to the workforce at a modest pace of about 100,000 new jobs per month, which is just sufficient to keep the unemployment rate from rising. Meanwhile, investors are digesting the impact of legislation on the healthcare and financial sectors, prospective outsized budget deficits, and likely changes in tax policy as the Bush tax cuts are set to expire at the end of this year. Consequently, the debate over whether the economy is on the road to self-sustaining recovery is likely to continue into the second half of this year and possibly into 2011.

Weighing these considerations, we have made some changes to our outlook, especially on the interest rate front. Previously, we believed the Federal Reserve would begin to tighten monetary policy later this year and that treasury yields would rise on the back of heavy treasury issuance. In the wake of the recent developments, however, we now expect the Fed to keep rates unchanged well into 2011. Nonetheless, we do not find treasuries attractive at current yields, and we are continuing to overweight corporate bonds, which offer better relative value.

Portfolio Outlook

With the Fed keeping interest rates “exceptionally low for an extended period” amid uncertainty over the strength of the U.S. economic recovery, we anticipate:

- Short- and long-term interest rates are likely to remain low in the near-term.
- Long-term interest yields are at risk to rise in the medium term as the economy recovers and Treasury issuance puts upward pressure on interest rates.
- Economic growth is likely to remain solid in the second half of 2010. The pace of growth may be more moderate than in past recoveries.

On our part, we plan to:

- Position portfolios for higher long-term interest rates and to opportunistically invest in TIPS.
- Remain overweight corporate bonds (investment grade and high yield) as we believe the risk premium is attractive relative to Treasuries.
- Continue to view Treasuries and government-related bond sectors (Agencies, MBS) as relatively unattractive.

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