



Philosophy

Fort Washington believes that investing in higher quality segments of the High Yield Fixed Income market offers the best alignment of risk and return. This provides the most favorable opportunity to outperform over a full market cycle while maximizing risk-adjusted returns.

Process

Fort Washington's High Yield Fixed Income process narrows the universe of available securities into a group of credits with attractive risk-return relationships. We de-emphasize sectors with unfavorable risk-return relationships and do not buy securities rated CCC or below. Credit selection is led by our experienced portfolio manager and our specialized team of credit research analysts. Fort Washington's larger High Yield Fixed Income positions are generally comprised of well-capitalized companies with proven business models and relatively strong credit ratings.

Investment Professionals

Brendan M. White, CFA

Senior Portfolio Manager
23 Years Experience

William H. Bunn, CFA

Senior Credit Analyst
24 Years Experience

Bernard M. Casey, CFA

Senior Credit Analyst
18 Years Experience

Timothy J. Jossart, CFA

Senior Credit Analyst
17 Years Experience

Anthony L. Longi, Jr.

Senior Credit Analyst
23 Years Experience

Kevin Seagraves, CFA

Senior Credit Analyst
14 Years Experience

Performance

During the second quarter, High Yield spreads widened materially but the impact of such was offset by declining interest rates. Concerns surrounding European sovereign fiscal issues coupled with uncertainty surrounding the regulation of U.S. financial markets resulted in spreads widening nearly 130 basis points. However, since interest rates declined significantly, the net result was a modest loss of principal offset by income resulting in flat market returns.

The recent volatility reflects 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. A bright spot remains in the corporate sector, where profits have risen significantly as margins have improved and top-line revenue growth has begun to expand.

Given this recent reduction in the confidence of the economic recovery, it is not surprising that lower quality (CCC-rated) issuers underperformed with a total return of -1.2%. Additionally, BB rated issues, which are more interest rate sensitive generated a positive return of +0.6% for the 2nd quarter. Our portfolios performed competitively given our higher quality bias and defensive philosophy and process.

Factors Contributing to Performance

As is often the case during periods of volatility, our sector allocation contributed more to our performance than did our security selection. Our overweight position to healthcare coupled with our underweight allocation to banks & thrifts and financials assisted with performance. We continue to look for opportunities to reduce our underweight allocation to banks & thrifts and financials as well as the Insurance sector as these sectors have become an increasingly large part of the market. Since these sectors can be volatile, we will remain very cautious with respect to such.

Although our overweight allocation to healthcare contributed to performance, we were less successful with security selection within this sector as our individual exposures detracted from performance. Similarly, Security Selection within the utility sector detracted from performance. Conversely, we were able to add to performance at the security level within the homebuilder and financial sectors.

Portfolio Outlook

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, although the risks of a "double dip" recession may have increased, we continue to believe the risk of such to be low in the United States and Asia.

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. 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 for interest rates. 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 favor High Yield, which offers attractive relative value. An improving economy, a declining default rate and positive technical factors should allow for High Yield to remain attractive. Although our expectations remain tempered, we think that High Yield continues to offer attractive relative value, particularly when compared to other fixed income asset classes.

We remain comfortable with our portfolio composition and continue to believe the portfolio is properly constructed. As such, we believe we are well positioned for the current environment.

High Yield Fixed Income

The strength of Fort Washington's High Yield strategy has historically been fundamental credit analysis with particular emphasis on avoiding problem credits. We believe this will continue to add value as negative credit events may have a material impact on returns in this lower return environment. We believe this core competency will provide considerable value to our clients.

We will continue to construct portfolios designed to exhibit less volatility than the broad market and deliver attractive risk adjusted returns. Our portfolios are designed for performance over a full market cycle with focus on protecting principal in down markets, a style that we believe will outperform over the long-term.

Opinions expressed in this commentary reflect subjective judgments of the author based on the current market conditions at the time of writing and are subject to change without notice. This publication has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy, or investment product. Past performance is not indicative of future results.



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