J W KORTH & COMPANY
INVESTMENT BANKING AND ADVISORY SERVICES

2012 SECOND QUARTER ACCOUNT MANAGEMENT REVIEW – July 15, 2012

"We believe most people desire to earn income, relax and retire with a comfortable portfolio of income generating liquid assets. We continue to define a "comfortable portfolio" as one that achieves the highest reasonable current income while being insulated by the highest possible degree of broad diversity from all imaginable economic shocks. This concept guides all our efforts." – James W. Korth, Managing Partner

We continue our basic recommendation that to achieve a "comfortable portfolio" and preserve wealth, our clients should strongly consider allocating most of their liquid assets to a managed portfolio of fixed income instruments selected from the full spectrum of security types and worldwide markets.

Currently, for all accounts, even those with higher tax brackets, we are recommending taxable instruments. This is because tax exempt bonds have generally risen to a level where even after a taxable bond portfolio of similar maturities and ratings is discounted for the tax exposure, we estimate the investor can potentially take home approximately <u>1.50% after tax more</u> than on a similarly designed tax exempt portfolio.

In what are thought to be efficient markets, why does this disparity exist?

We believe there are primarily two reasons. First, there is a basic psychological delight in having income that is tax free at some level. Second, there is a simplicity factor. Many investors, especially as they age, desire to simplify their day to day lives. Tax free municipal portfolios provide predictable income without any tax worries, making life as simple as possible on the investment side. Both of these factors contribute to many wealthy investors looking no further than municipals. Consequently, the market is currently richly priced with low yields.

For instance, at the time of this writing, searching the broad municipal market for bonds which yield 3.50% or higher and have a rating of BB-BBB and a maturity less than 7 years we only see 27 different offerings. All of these are for decidedly weak credits like the City of Detroit or Jefferson County Alabama.

On the taxable side a 6.50% (or after tax yield of 4.55% in the 30.00% tax bracket) search of BB-BBB with a maturity less than 7 years shows 195 offers from approximately 80 different credits. The disparity between taxable yields and tax exempt yields is so great that we will currently recommend to almost any client to sell all the tax exempt bonds at high premiums, pay a small capital gains tax, and replace the bonds with a diverse portfolio of mid-grade corporate. By doing this now, many municipal investors in a tax bracket of 30.00% or lower can expect to increase their annual income by up to 1.50% after tax.

The math regarding this move is simple. If your current municipal portfolio has a current yield of 3.50% and a face value of the bonds of $1mm, you earn $35,000 tax free per year. If that portfolio has a value in the market of 108% because of market appreciation, you could spend $1,080,000 on a diversified portfolio of mid grade corporate bonds yielding 7.00%. This would create income of $75,600 per year. If you pay 30% in taxes, that would be an after tax income of $51,500 or about $1,500 per month more after tax income.

Special Note: The relative values between the taxable and tax exempt markets are constantly monitored by our firm. Being closely watched currently, is the effect of the three (soon to be possibly four) municipal defaults in California. It is possible that the media attention to these distinct situations and additional possible defaults in Alabama and Michigan may cause a decline in municipal values changing our view of the disparities between the markets. Investors should be aware that these situations still represent just a very small percentage of all the municipalities that have bonds issued in the US and that a properly diversified portfolio should see little effect.

For taxable bonds, we continue to believe the highest reward vs. risk is achieved with bonds in the BB-BBB categories. Yields in the BB-BBB category can be achieved that are as much as 4.00% higher than stronger rated bonds. From 1981 -2010 according Standard & Poor's, the average annual default rate for bonds with the BBB category is approximately 2/10 of 1.00% and for the BB categories is approximately 9/10 of 1.00%. We believe our credit expertise can make these rates much lower for our accounts.

Consequently, if held to maturity, a highly diversified portfolio should realize very solid returns with very few to no coupon payment disruptions. To add a higher level of security we look for secured bonds and bonds with Standard & Poor's Recovery Ratings of 3 or lower as presented on Bloomberg. This professional estimate means that even if issuer chooses to reorganize, that that bondholders are estimated to receive 60-70% of their principal. Add that to the coupons that would be received before any payment disruption, and a likelihood of no loss becomes quite possible. We also actively monitor issuers and sell bonds that we believe are showing strains and could possibly fail to make payments.

As we ended the second quarter, the US economy was showing substantial slowing. There appears to be pressure building for another stimulus of Quantitative Easing by the United States Federal Reserve (translate: money creation program). This may eventually create a higher level of inflation, though CPI has not yet begun to inch up. On a positive note, we are seeing some stabilization, and in many areas moderate increases in housing values for the first time in several years, and gas prices have declined substantially which always seems to revive our country's economic numbers a few months later.

The Consumer Price index showed an annualized increase of 2.7% in March, 2.3% in April and 1.7% in May. While we continue to believe inflation is expected to remain in the low 2.00-2.25% range, should inflation increase substantially, then we can also expect interest rates to rise. In view of that scenario we would begin shorten the average life of our portfolios.

Regarding the general level of US interest rates, the prime driver – the Federal Reserve Board of Governors – has pledged to keep their benchmark rates near zero until late 2014 and now it has been reported that discussions may be underway to make the target into 2015. As a result, we have extended our target portfolio average life out to 7-9 years.

A seven year average life portfolio today if unchanged until late 2014, will be a four and one half year average life portfolio. For a four and one half year average life portfolio, each 1.00% up move in interest rates reduces the market value of the portfolio approximately 3.00%. We find this level of volatility quite acceptable as our investors can always hold their bonds to maturity to achieve full principal value.

Another big support factor has to do with the yield curve. Interest rates for short maturities are traditionally lower than interest rates for long maturities. As portfolio bonds move toward maturity they naturally increase in principal value as a higher coupon longer bond becomes a higher coupon shorter bond.

In extending portfolio maturities in the first quarter, we chose to add several high quality, highly liquid issues of preferred stocks with yields in excess of 8.00%. This quarter we have held these securities and have watched them go to higher levels. These have increased in share value approximately 6.00% on average since their acquisition. We expect them for the near term to go higher in price and lower in yield. Many of the preferred stocks we bought near 8.00% are now yielding in the 6.00% range. We will carry on monitoring their performance continuously with a view toward reducing the positions in the face of a change in rate sentiment.

We did sell one our preferred positions because of a changing credit forecast. Second quarter bond purchases saw us continue to acquire hard line US telephone companies with strong bases and good cash flow, collateral trust bonds for airplanes, and some mortgage portfolios which we believed had strong assets.

Because the world financial community is now very international, and because the US dollar may decline somewhat as a reserve currency over the next few years, our portfolios also have strong international components. We focus on the currencies of growing countries like Russia, Brazil, Australia, New Zealand, Turkey, and Norway and find exposure there through issues from stronger US banks and supranational corporations with very strong ratings. We avoid government bonds despite their high ratings because of their poor record in dealing with their creditors when things get really tough. Historically, in our experience we have seen that large private entities will often be good credits even when the governments are not.

We monitor the currencies of many countries and attempt to enter and exit them at appropriate times. Currently we are avoiding Euro denominated bonds as we believe the scenario there is unpredictable as the European Union countries must adjust their economic policies to deal with the large amount of debt that has been incurred and the prospects for slow or negative growth. We are closely monitoring the Euro however. It has declined to the 1.20-1.22 range. Should it continue to parity with the US Dollar, it may be enough to increase the business activity of Europe and help heal their fiscal and monetary imbalances. When and if this appears to be imminent, there will be some big opportunities to purchase higher yielding bonds from strong European entities.

In the second quarter, we continued to limit our international purchases as the dollar has shown safe haven strength and as the central banks for some of the stronger international currencies announced an aim to reduce thier currency values and lowered their interest rates. This was particularly pronounced in Brazil and its Real went to a level of more than two Real to the US Dollar from a high of about 1.5. At this level we are closely monitoring a chance to reposition some funds in that currency. Fortunately, holders of Brazil currency are enjoying very high coupon rates which have largely offset the currency level change when compared with other opportunities.

Turkey continues to be under pressure with both Iran and Syria on its borders but the high coupons on the bonds acquired there appear to be steadily insulating investors from the currency move lower. We continue to monitor the Housing Finance Bonds in Iceland where our portfolios own first mortgages on the Iceland houses and continue to collect currency but have been restricted by trading rules by the Iceland Central Bank to an offshore exchange rate which we find too low to recommend conversion. We do believe that the economics of Iceland are slowly improving.

We did invest portfolios in Norway and believe the Scandinavian countries and Australia and New Zealand showed some solid value as they appear to have values that are heavily influenced by their large trade books with China.

Overall, our portfolios reflect our best judgments as to the direction of the financial markets with a very strong emphasis on diversity (which we believe is the largest driver of safety) and on reasonable yields. These can be selected by finding those instruments that appear in the marketplace without informational support and need investigation before placing in our or our client's accounts. It is these instruments that often appreciate after purchase and therefore show the most value. Our managed portfolios are considered for these opportunities before they are offered to other clients who manage their own accounts.

During the second quarter in the US, we saw a minor increase in principal values and a lowering of overall market interest rates, primarily in stronger credits. Simultaneously we saw weaker credits decline in value as the economy appeared to slow. With gas prices at the current level we believe the slowdown might begin to reverse so we are cautiously starting to buy some of the weaker credits for appropriate accounts. While we had to adjust our Target Yield for our Mid Grade 33 Portfolios from 7.50% to 7.00% in the first quarter we have held it steady in the second quarter.

The second quarter saw a diminished amount of new issues and late in the quarter the European financial crisis began to come to the forefront again and volume across the board slowed. As we expected, the second quarter saw a modest fall back in prices and a rise in bond yields as more timid investors maintain excess income in cash and wait for clarity in the European situation. We got some level of clarity as the European Union agreed to form a central banking authority and provide some type of Pan European coverage for all depositors.

We believe this was a major step forward for Europe. And is another step in what appears to us to be the slow and fitful integration of the European Union into a United States of Europe. We believe this process will continue in fits and starts for years to come with some countries leaving the Euro and others joining. The resulting news sensationalism may keep a bit of a damper on the world stock markets but the bond markets should remain relatively stable by comparison. Lately, we have been more confident in Europe and did purchase the bonds of the number one cable company in Spain at yields near 9.00% denominated in US dollars.

We believe the United States does not have a very large exposure to Europe as only about 14% of our international trade is delivered there and our banks appear to have made adjustments to the their exposures. We have found that these periods of adjustment to international news create values in the marketplace and we expect to continue our portfolio purchases and may be able to raise our target yields back toward the 7.50% range during the summer.

Here at home we are watching the presidential election in the US closely with an eye to the impending US budget and tax events scheduled for a lame duck congress just after the November presidential vote. The argument between the haves and have-nots will be intense as the Bush tax cuts are set to expire in the face of the largest deficits our government has faced in a long time. This big negotiation by our nation has the chance to roil markets during the late summer and fall. We have faith that it will be resolved and our nation will stay on a solid financial footing but there will be real pain as the burden of social responsibility shifts from the US Government to more local entities like states and municipalities.

One major concept which seems to be slowly coming to the forefront is that our unemployment situation in the country is not related to a bad business environment. Indeed many companies are doing very well but they are doing very well with fewer people. This is because of huge gains in productivity from robots to manufacture to robots to take our tolls on freeways and kiosks to sell us airplane tickets. This has created, at least for now, a whole class of unneeded workers and we are going to have to take care of them and reeducate them.

We will adjust and we believe the entire process may present excellent buying and selling opportunities for committed fixed income investors.

We trade the positions in our portfolios for two reasons.

First, according to Standard & Poor's research, BB rated bonds average 5 years from the time of that rating to the time they could default and BBB bonds average 7.5 years. This gives us time. We follow economic trends and if the risk reward scenario for a certain bond issuer deteriorates to point where we believe there is principal risk we will sell it and replace it with a better issue.

Second, bonds often appreciate - especially as they move closer to maturity. We are always looking to take substantial gains on individual securities and then replace them with instruments we believe have additional gain potential while keeping our portfolio parameters within target ranges.

During the first quarter we sold a lot of longer and shorter corporate bonds and municipal bonds at extraordinary profits and reinvested many of them in longer maturities as we adjusted the maturities longer. Many of these bonds earned as much as three years in interest by taking principal profits.

Overall, during the second quarter we did little strategic selling. We sold a finance company and are monitoring a Brazilian bank that has had difficulties. We also sold some preferred stocks of insurance companies which we felt had downside potential. We also sold a lot of municipal tobacco bonds as the trends is for fewer and fewer cigarette sales and Moody's and others are predicting high default numbers for the $20 billion in tobacco bonds held by investors.

Lastly, we tailor each portfolio to the specific orientation of our clients. As an example, during the second quarter we established a new account that wanted to take more risk and have a higher income than currently offered by our Mid-Grade 33 Global Managed Bond Account. For this client we have agreed to purchase lower grade bonds with yields as high as 10.00% while still providing wide diversity.

While all investing has risk and our portfolios may not perform up to expectations, we believe they represent the best risk vs. reward scenario for investors who want income from their investment account while preserving their wealth. For many years, nearly 100% of our clients have earned solid aggregate returns on our bond portfolios. A large test of our portfolios occurred during the depth of the early 2009 market slump. In aggregate, our accounts were down only about 15.00% in market value while nearly all of them maintained a steady flow of interest income.

Overall, the professionals at J W Korth are watching the markets worldwide every business day and collaborating with dealers large and small to bring focus and the best results to our portfolio customers and help them earn income, relax and retire with a comfortable portfolio of liquid assets.

This report is updated quarterly and the principles applied to our managed accounts.

As always, we thank our customers for their business and faith in our efforts

Sincerely,

J W KORTH & COMPANY