J W KORTH & COMPANY
INVESTMENT BANKING AND ADVISORY SERVICES

2012 THIRD QUARTER ACCOUNT MANAGEMENT REVIEW – October 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 which achieves the highest reasonable current income while being insulated by broad diversity to the highest possible degree from all imaginable economic shocks. This concept guides all our efforts" – James W. Korth, Managing Partner

Major Market Developments:

- The Bush tax cuts are set to expire at year end and the capital gains tax rate could rise to 23.8% and the ordinary dividend and interest tax rate to 43.4% if no action is taken by Congress.
- The taxable and tax exempt fixed income markets have risen to an extraordinarily high level. This fact together with the possible expiration of the Bush tax cuts have caused us to sell bonds that have substantial profits and we are carefully seeking solid returns in other markets.
- The Federal Reserve has extended its outlook for low interest rates to mid-2015 and chose to start buying $40 billion dollars of mortgage backed securities per month.
- The Federal Reserve has taken the unprecedented step of focusing its buying of mortgages activity on the contingency of a lowering of the unemployment rate.
- The European Central Bank has committed to purchase bonds of countries in Europe who apply to the European Stability Fund, and markets have risen substantially as a result.

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 income instruments selected in the broadest possible way from all security types and worldwide markets. <u>This statement is changed from previous quarters to remove the word "fixed". We believe the markets for fixed instruments have generally risen to unprecedented levels where value is hard to identify.</u> Consequently, for the first time in many years we are considering certain funds that have the potential for good cash flow and broad diversity or other factors that make their investment profile more attractive than bonds.

US Dollar Denominated Bonds

As we ended the third quarter, the US economy was showing substantial slowing in the manufacturing sectors but housing seems to be in a recovery. The Federal Reserve moves on mortgages appear to working. What is discussed in the Federal Reserve minutes from September is “structural unemployment” caused by a “skills gap.” What this means in simple terms is that we have about 10% of the population that has not reached a level of expertise with modern systems to be employable. Here in Miami in the last couple of years we have lost all the parking meter attendants, the toll takers on our expressways, parking attendants in parking garages, and the meter readers for Florida Power and Light as the company installed electronic ones. Previously, bank tellers, reservation personnel, checkout clerks at stores and pharmacies, and airline ticket takers have all lost their jobs. All of these jobs are in the low skills category. I believe the Federal Reserve recognizes this and is hoping to get unemployment down with basic labor jobs in the construction industry. We think this may work for a time but may bottom out as demand for construction eventually flattens in the face of our aging population. Consequently, we are going to be careful to assess any bullishness that comes in the next few months.

This housing recovery may eventually create a higher level of inflation and indeed the CPI seems to be inching up along with energy costs. On a positive note, we are seeing some stabilization in the housing market and in many areas of the country, moderate increases in housing values for the first time in several years. Simultaneously, with gas prices falling in the Spring and early summer we predicted an increase in economic activity which showed itself in the late summer unemployment reports. But now with gas prices back near their highs we need to monitor a possible slowing. With bonds at their highest levels in years, either a growth or a contraction scenario could be a negative for prices of the longer maturities. If the economy suffers a recession, fears about the sustainability of credits may bring prices lower, and should the economy do much better, longer interest rates may rise and bring prices lower. Further clouding the picture is the possible end of the Bush 2001 Tax Cuts slated for January 1, 2013 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. The really important aspect of this law for investors is that the capital gains tax will rise to 23.8% from currently 15% along with tax rates as high as 43.4% on interest and dividends (both these figures include the new 3.8% Medicare Tax).

Further bringing forth possible real storms are the employment tax increases slated to occur on January 1, 2013 where withholding will rise 2.00% and certain budget items may be automatically sequestered putting a large damper on the economy and possibly affecting the credit quality of certain bonds and the perceived credit risk of bonds in general.

In accordance with the discussion above, we have learned that a large part of the high yield bond issuance in the past few months has been to provide the issuers with the cash to pay large dividends to capture the possibly expiring 15% dividend rate. This is changing the balance sheets of many issuers and could put pressure on higher yielding bond prices in the coming months.

For all the reasons above we are keeping large cash positions for the rest of the fourth quarter and selling many positions that have large profits to capture the 15.00% tax rate on the gain and defray the 43.4% that could be charged on the future interest. We believe forgoing a couple of months' interest is the safer policy rather than possibly watching all the value created by a high priced bond market disappear along with the low tax rate.

We are also going to reassess the values between the tax exempt bond market and the taxable bond market once the Fiscal Cliff tax decisions become clear.

In our managed accounts, we are selling US Dollar bonds that have substantial capital gains profits. Many of these bonds have one or even two years of interest value worth of capital appreciation. We can capture this at the currently low capital gains rates now and reassess in a few months.

International Bonds

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 are currently focused on the currencies of growing countries like 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. In the last 200 years there have been over 200 government bond defaults including nearly every major nation except the United States and Britain. Historically, and in our experience, we have seen that large private entities will often be good credits even when the governments are not. This is because the consequences for private entities are generally bankruptcy and dissolution where governments can just go on and on.

We monitor the currencies of many countries and attempt to enter and exit them at appropriate times. In the third quarter, we watched the dollar weaken somewhat against major currencies including the Euro as there seems to be a concerted effort to move US interest rates lower and make the dollar denominated issues less attractive. This has brought down yields in other currencies as many of them reduced their basic interest rates to remain competitive.

Turkey continues 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.

In Iceland, economics continue to improve and we have seen the government there begin to offer an auction to buy back ISK that is held offshore in exchange for Euros. The upconming auction is slated for November 7, 2012. We are monitoring the results of the auction and will recommend action when appropriate. Fortunately, most of our customers own bonds that are still paying interest and ultimately the investment in Iceland may prove fruitful despite the patience that has been required to wait for value to return. We do take some credit for the auction process being instituted in Iceland as we traveled to Reykjavik and proposed a similar process to the Central Bank of Iceland in the summer of 2010.

The South African Rand is under pressure as S&P has downgraded South Africa's sovereign rating to BBB and leaving it on Credit Watch negative due to unrest in the country. We are monitoring this situation and may sell our South African Rand holdings in managed accounts at some point. Fortunately, the yield on the bonds we have placed in this currency are substantial and are offsetting a good portion of the currency decline.

The Brazilian Real fell dramatically in the second quarter as the government intervened earlier this year to move it down to support its export market. Since then it has generally stabilized in an area just over 2 real to the dollar and we are making strategic purchases again there. Fortunately for our holders who bought at higher levels, the very high coupons they enjoy are protecting the ultimate values of their investments there. Brazil's metrics with a strong trade surplus still look very fine compared to many other countries.

China is lamenting their slow down and are only growing at 7.5% (hardly a slow down by Western standards). We have placed some clients in Chinese denominated bonds and believe the fact that both parties are railing against the low value of the currency vs the US Dollar gives us a view that we have little downside currency risk there.

We are still staying out of the Euro as we believe it may fall against the dollar to help Europe recover from a broadening recession. We have purchased some telecom bonds with strong fundamentals, but they were denominated in the US dollar. Here we believe that despite the noise from dissenters, the European Central Bank has literally no choice but to monetize the debt of the weaker countries if it wants to avoid the breakup of the Euro. Eventually we believe this will cause inflation to accelerate there.

Australia and New Zealand showed some solid value as interest rates are higher than in the US and exchange rates in these countries have remained relatively stable.

Currently we are seeking the best means to open positions in India. India's growth has slowed recently and as a solution the government there is beginning to open the previously restricted Indian capital markets to worldwide investors. We are seeking strong credits and an entry point for investment in the Indian currency (INR).

Certain Funds to Be Added to Accounts

With the bond markets in general at such lofty levels, we have sought out alternatives to provide value to our managed accounts at the target yield levels. These funds are from three basic categories.

1. Leveraged Emerging Market Funds – The emerging markets across the world are benefiting from investments being made by large pools of capital. Manufacturing and infrastructures in many countries are improving dramatically and with them the economies of emerging countries are showing solid growth while the economies of the major industrialized countries are languishing under

huge global competition and extraordinary debt loads.

The whole picture is pretty simple to understand. As manufacturers in industrialized countries outsourced jobs, the emerging economies grew, and the industrialized countries borrowed money to pay for the jobless and those who could not save enough for retirement. This basic trend may be reversing itself slowly as trade deficits narrow but for now the emerging markets, having been energized by this trend, are moving forward.

While we manage high grade international fixed income instruments for our accounts, it takes a focused team of highly experienced professionals to reach into different countries and make good decisions to purchase lower grade debt instruments with strong prospects. We have funds identified with excellent managers to do just that. Further, these funds have access to the repos markets where they can loan bonds out at incredibly low interest expense and with prudent levels of leverage that can enhance investors' yields. We are therefore judiciously adding these funds to our Global 33 Portfolios.

2. Buy-Write Large Cap Stock Funds – These funds were the darlings of the market five years or so ago and now are languishing with market values at discounts as high as 14.00% to Net Asset Values (NAV). They have strong dividends in the 9.00% plus range. One manager in particular is using funds cash to buy in shares of its funds to bring their market values up to their Net Asset Values. This is the equivalent to Microsoft buying in its own shares with its excess cash. We believe these funds are a good opportunity because of the high dividends, the push toward NAV from a deep discount level, and the very strong stocks they own with the accommodative position of the Federal Reserve under the markets.

3. Leveraged Bond Funds –These funds are both taxable and tax exempt in nature and many have yields much higher than can be currently purchased in the bond markets. They generally have large capitalizations and very wide diversity and own bonds purchased in periods when interest rates were much higher. Further, they can access the short term debt markets at levels that are unachievable for all but the largest pools of capital. Prudently applied, this leverage can push yields to substantial levels. These funds are being monitored for an entry point when we believe the bond market has settled at a possibly lower level than present.

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 clients' 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.

World Wide Interest Rates and Conditions

During the third quarter, for the US and many other countries, we saw a major increase in principal values and a lowering of overall market interest rates across the board. 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 maintained our 7.00% target by focusing on the diversity provided by the funds described above and taking profits where high rates of capital gain can be captured.

The third quarter saw a dramatic increase of new issues and late in the quarter this seemed to slow the rise in bond prices, but did not appear to push them down. All the price increases and issuance seemed to emerge under a reduced fear that Europe may fragment, as the level of clarity provided by the European Central Bank commitment to purchase bonds of weaker countries provided a feeling of stability. We now are expecting Spain to approach the ECB for a bailout at any time but the markets appear stable with the strong hands of the ECB and the Federal Reserve in accommodative positions.

We continue to believe that Europe is going through a slow and fitful integration into the United States of Europe and Greece and possibly others may leave before this happens. We also believe the United States does not have an unmanageably 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 believe the European Union is ready for a Greek exit and that it might be best for the Greeks to go back to the Drachma and develop their exports to mend their economy. There is also speculation and reports among writers of the Financial Times that the ECB may just plain forgive the debts of certain nations from whom it acquired bonds to support their markets. These writers also speculate that the US Federal Reserve may do just that at some point with the $1.4 trillion in US treasuries it currently owns. If this is done, of course it could cause inflation, but it is a small portion of the overall $52 trillion of total financial assets (Z.1 Report from the Federal Reserve) held by households and non-profit organizations. Is this a real solution to our debt problem and to Europe's debt problem? It is certainly a shocking one that could breed inflation but as we show here against the value of all household and nonprofit financial assets it would currently be only about 2.7%.

We have found that these periods of adjustment to international and domestic news create values in the marketplace and we expect to ramp up portfolio purchases on market weakness. We are monitoring our presidential election very closely, along with the changes that might happen as a lame duck congress and possibly a lame duck president have just 55 days after the election to avoid the cuts to our national budget and the end of the Bush tax cuts.

We think there is a large chance that nothing might be agreed upon and that we might open the New Year with a major change in our national budget and our tax rates. Because the dividend rate and capital gains rate may rise dramatically it could make year-end profit taking this year extraordinarily high as people try to capture their last shot at a 15% capital gains tax rate and may sell high dividend stocks which may have a 43.4% tax on their cash flow. If this happens it should create some buying opportunities and we are keeping liquidity strong in our portfolios for this eventuality.

Whatever happens, we will adjust. But 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 the 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 and we are always looking to take substantial gains on individual securities and then replace them with instruments we believe have additional gain potentials while keeping our portfolio parameters within target ranges. This basic trading is supported with our reasons in our trading notes and these are available to all our affected clients.

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 and third quarters we did little strategic selling but are now selling in earnest in the fourth quarter certain bonds with high capital gains. We believe this may continue right into the end of this year as we face the possible increase in the capital gains rate and tax on interest described above.

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 Portfolio. 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. Aggregately 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 are applied to our managed accounts.

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

Sincerely,

J. W. Korth & Company