

## ABOUT FORT WASHINGTON INVESTMENT ADVISORS, INC.

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We are writing in light of the extraordinary events in financial markets in recent weeks. A series of cascading developments that included the de facto nationalization of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and subsequent failure and consolidation of several leading financial institutions culminated in credit markets becoming frozen, financial share prices plunging and money market funds losing assets last week.

The Bush Administration has responded by announcing measures to bolster the financial system that are unparalleled in scope. The keystone call to action is for a government entity to purchase and manage \$700 billion dollars of illiquid mortgage-backed securities that have eroded the balance sheets and liquidity of financial institutions and left them vulnerable to withdrawals. Congress is expected to move swiftly to enact legislation given the gravity of the situation, although it may require added protection for homeowners facing foreclosures and other changes.

Given the historic importance of these developments, we want to share our thoughts and explain how we are positioning portfolios. Most of all, we want to assure you that your investments are in strong hands, with Fort Washington Investment Advisors being part of the Western & Southern Financial Group, a corporation that holds one of the highest capital ratios and credit ratings in the financial services industry.

Six months ago we provided the following assessment, which we still adhere to today: "The current environment is as challenging and complex as any in the past four decades. Investors who are close to their strategic asset allocations and have well diversified portfolios should be in position to ride out the storm. On a tactical basis, we think high-quality portfolios are likely to outperform until there is greater clarity on the economy and financial system. Investors with such portfolios should be in position to capitalize on opportunities in credit markets and the stock market later on."

In conclusion, these have been extraordinary times, and we have been monitoring your portfolios very closely. We will continue our communication with you as market events continue to unfold. However, should you ever have any questions related to the markets or your portfolio, please do not hesitate to contact us.

Nicholas P. Sargen, PhD  
Chief Investment Officer

Maribeth S. Rahe  
President and Chief Executive Officer

*Q1: What factors have caused financial institutions to fail or require government assistance?*

A: While details vary among individual institutions, three factors are commonly associated with the most troubled:

- (1) All had large holdings of illiquid mortgage-backed instruments, including derivatives, that are difficult to value.
- (2) All had highly leveraged balance sheets as reflected in high ratios of assets to tangible capital (averaging more than 25 times for all investment banks and more than 30 times for Bear Stearns and Lehman Brothers).
- (3) All had significant mismatches between their liabilities and their investments as part of their business model.

Once creditors of these institutions became concerned about their viability and withdrew funds, the troubled institutions were forced to liquidate positions at distressed prices. The result was either a liquidity crisis or a bankruptcy.

*Q2: What caused the Bush Administration to unveil such a sweeping program of assistance?*

A: Essentially, the Administration has conceded that the current crisis is systemic in nature. When the Treasury and Federal Reserve engineered the sale of Bear Stearns to JP Morgan in March, policymakers provided \$29 billion of backing to complete the deal, and the Federal Reserve unveiled a series of measures that were designed to reduce the risk of contagion. Six months later, however, Secretary Paulson was reluctant to provide similar backing to potential acquirers of Lehman Brothers, because other institutions were vulnerable and he wanted to dispel the notion of “too big to fail.”

While Paulson and the Fed were dealing with each institution on a case by case basis, they soon realized that a comprehensive solution was necessary, because an increasing number of financial institutions were having difficulty obtaining funding from private sources.

*Q3: Will the plan work?*

A: It's too soon to tell, as there are few details on how the plan will actually work. The key ingredient needed to stabilize financial markets is evidence that the declines in prices of homes – which are the collateral for mortgage backed securities – are about to end.

While we think this is unlikely before next spring at the earliest, the plan nonetheless should improve liquidity and activity in the mortgage arena in the meantime. If it helps to stabilize housing prices next year, it will be viewed as a success. Whatever the ultimate outcome, we believe the plan is better than doing nothing, which would risk a run on financial institutions. In this respect, we view enactment of the plan as necessary to stabilize markets, but it still may not be sufficient if the economy and financial sector deteriorate further.

*Q4: How, if at all, would enactment of the plan alter your investment strategy?*

A: We think it is premature to make major changes in our investment strategy at this time. For the past 12 months, we have been positioning investment portfolios defensively by maintaining larger-than-normal allocations to cash, by underweighting financials and by favoring higher-quality names. At the same time, we have been reluctant to hold large treasury positions in our bond portfolios, because we do not believe they offer good long term value. We are always looking for opportunities where there has been indiscriminate selling of securities.

We expect volatility in financial markets to diminish in the near term for two reasons. First, investors need time to assess the Paulson plan and Congressional modifications to it. Second, the latest government actions to halt short sales on financials should help bolster that sector for a while. If that is the case, investors once again can focus on fundamentals such as the prospects for the economy, inflation, interest rates and the performance of the U.S. dollar.

*Q5: Is a U.S. recession inevitable?*

A: The risk of a downturn has increased, but we do not foresee a deep recession provided conditions in the financial system do not deteriorate further. While the economy fared better than expected in the first half of the year, the two factors that bolstered it – strong export growth and the tax rebate program – will be less powerful in the future. Previously, Europe, Asia and Latin America all appeared to be shielded from U.S. developments. But the latest data now suggest both Europe and Japan are close to recession, while the emerging economies are slowing. Consequently, we believe U.S. export growth will moderate. Meanwhile, consumer spending, which accounts for 70% of the U.S. economy, has been very sluggish, as households feel the impact of modest growth in their incomes, declines in their net worth, and higher food and energy costs.

Finally, we are also monitoring developments in housing closely, because it is at the epicenter of the U.S. financial storm. On the positive side, there are indications that housing starts may be stabilizing. Nonetheless, we believe housing prices, which have already fallen by about 20% in major metropolitan areas, could see additional declines of 5%-10%, mainly due to the large inventory of unsold homes.

*Q6: Are the massive government bailouts likely to be inflationary?*

A: Not necessarily. The main drivers of inflation in the next 12-18 months will come from U.S. and global economic conditions rather than government spending and deficits. The key factor behind the recent slump in oil and commodity prices and the turnaround in the U.S. dollar, for example, has been the weakness of the global economy, which we expect to continue. If oil prices remain around \$100 per barrel or less, headline inflation should fall from a peak of about 5 ½% to about 3%, while core inflation (that excludes food and energy) should hover around 2 ½%. The latter mainly reflects the effects of modest wage increases in recent years and continued high productivity growth.

Over the longer run, inflation could accelerate if the federal government spent massively and the Federal Reserve purchased government debt at low interest rates. (Note that the ultimate impact of the Paulson plan on the federal deficit depends on whether the plan makes or loses money on asset purchases and sales, rather than on the size of the program.) Once the economy stabilizes we believe the Fed will increase interest rates much faster than it did in 2004-2006. In such an environment, we would expect treasury yields to increase significantly from their current low levels, while corporate spreads versus treasuries would likely narrow.

**QUESTIONS? CONTACT US.**

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