

# Johnston Investment Counsel

## Research • Analysis • Results

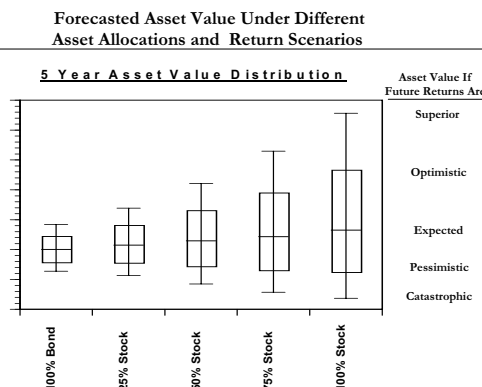
Johnston Investment Counsel's (JIC) comprehensive portfolio management service (CPM) is designed to meet a client's total investment needs. It is the one JIC service that combines the best attributes of each individual investment strategy into a single service. Specifically, JIC's CPM service includes:

- Asset allocation development,
- Ongoing management by JIC using its style rotation, index plus and mutual fund management, and individual stock management approaches, and
- Quarterly communication.

### Asset Allocation

The mix between various asset classes will likely have a significant impact on a portfolio's future market value, return, and risk characteristics. Therefore, it is one of the most important decisions a client can make. In assisting clients develop an appropriate asset allocation, JIC uses a combination of quantitative and qualitative inputs.

Quantitative inputs are generally cash-flow (contributions & disbursements) related. In conjunction with JIC's return and risk estimates, a financial model is created to determine the effect, over time, *different asset allocations and return scenarios may have on the future market value of a client's portfolio.* The following chart highlights the range of 5-year asset values using different asset allocations and return scenarios.



Qualitative inputs are questions that, based upon the client's response, gauge their willingness to accept investment risk. In determining the "correct" asset allocation, JIC's goal is to maximize the probability that a client's financial goals are reached within their parameters for accepting risk.

### Ongoing Portfolio Management

Depending on several client-specific factors, JIC may use a single investment approach or may blend multiple strategies in constructing client portfolios. These strategies include:

- Style rotation using JIC's index plus and mutual fund management approaches, and
- JIC's individual stock process.

If JIC's individual stock process is used, the client and JIC predetermine an appropriate individual stock allocation. For example, JIC's individual stock portfolio may represent 50% of the client's equity allocation.

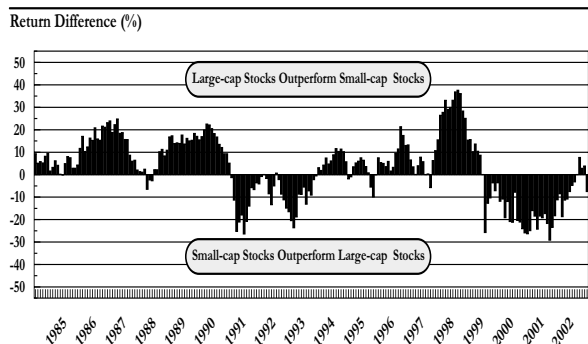
### Style Rotation: Background

Within the U.S. equity market there are different company size ranges (large, mid, and small) and investment approaches (value, core, growth). With respect to bonds, there are different maturity (short, intermediate, and long), and quality segments (investment grade, high yield). International and emerging market stocks and bonds are also investment categories that should be considered.

History suggests investment styles do not always perform the same -- and this creates the opportunity to add value. The chart on the following page shows the rolling 1-year return difference between large and small-company stocks.

Comprehensive Portfolio Management

### Rolling 1-Year Return Difference Between Large- & Small-cap Stocks



It is interesting to note that the return difference is often quite large and tends to last -- in many cases -- for a period of years. A similar chart can be shown for the value/growth investment approaches, domestic/international stocks, as well as various bond investment style categories. *JIC seeks to enhance broad market index returns by adjusting the portfolio's allocation to take advantage of these "style trends".*

#### Investment Process

JIC has identified various fundamental, macro-economic, and technical characteristics that help explain future investment style trends. Examples include:

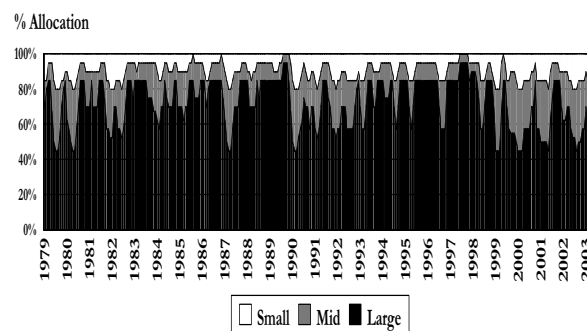
- Relative price/earnings
- Leading indicators
- Recent return patterns

Using these factors, JIC forecasts expected return differences for domestic/international stocks, as well as each company size and investment approach segment. Once a *meaningful* style-trend is identified, JIC will adjust the portfolio's allocation.

In constructing portfolios, each company size, investment approach, and domestic/international segment has a minimum, neutral, and maximum allocation range. These ranges are designed to ensure sufficient portfolio diversification but provide enough opportunity to enhance future returns.

Using JIC's company size model, the following graph provides an example of the historical domestic company size allocation. This type of allocation should allow for return enhancement while maintaining a "base level" of portfolio diversification. JIC also uses domestic/international and value/growth models in managing portfolios.

Company Size Allocation  
(Large, Mid, & Small Company Stocks)



#### Portfolio Construction

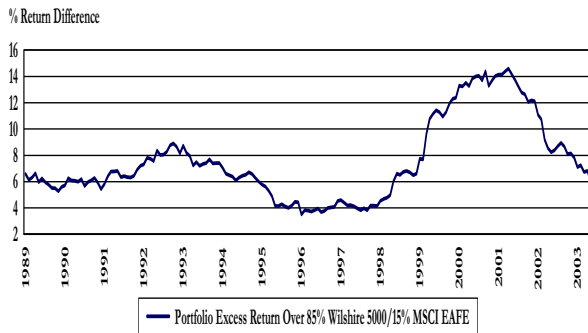
Partially due to their cost advantage, index funds have been consistent above-median performers in the large-company market segment. However, in some of the less efficient market segments (mid, small, and international), active management has historically been more competitive.

As a result, in constructing style-rotation portfolios, JIC tends to use *style-based* index funds in the large-company segment and a combination of index funds and active management in other equity market segments.

#### Does It Work?

The graph on the following page shows the *return difference* between JIC's index-only style-allocation portfolio and a benchmark index that consists of 85% U.S. stocks and 15% developed international stocks.

Rolling 3 Year Return Difference  
Portfolio Return Less Index Return



Clearly, these backtested results, while not providing a future return guarantee, suggests that this approach may consistently add value.

### Individual Stock Process

JIC's stock selection process seeks to invest in companies with the following attributes:

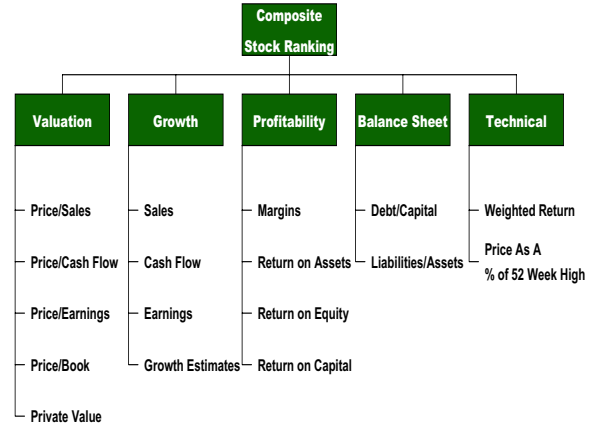
- Growing sales, cash flow, and earnings,
- Profitable as measured by margins and return on capital measures,
- Relatively strong balance sheets,
- Whose current valuation and stock price, in our opinion, does not fully reflect the companies future prospects.

JIC is not driven by short-term trading strategies, but by fundamental analysis. We purchase stocks that not only meet our fundamental criteria, but are selling at a significant discount to our target price. Assuming the fundamental outlook for the company does not change, JIC will be patient until the stock appreciates to our target price estimate.

### Investment Process

For stocks with market capitalizations above \$100 million, JIC calculates a composite stock ranking versus all other stocks in the universe, specific sector, and industry.

The composite stock ranking is based upon five major categories: valuation, growth rates, profitability, balance sheet, and technical measures. Each category has several underlying variables used in calculating the category ranking.



Stocks that have a composite ranking in the top one-third of the universe or sector are eligible for further consideration. In addition, stocks with above-average expected returns, based upon JIC's expected-return models, may be considered further. To learn more about JIC's individual stock process either contact us or go to [www.jicinvest.com](http://www.jicinvest.com).

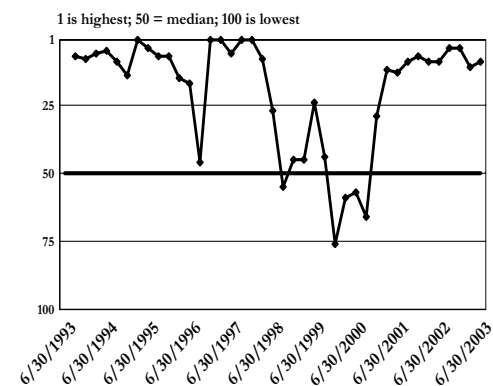
### Manager Search and Selection

JIC uses actively managed mutual funds in those market segments in which active management has proven competitive to index funds. JIC's manager selection process uses a combination of quantitative criteria and qualitative analysis in identifying managers for a specific style category.

In selecting appropriate candidates, JIC puts its primary emphasis on the manager's ability to consistently outperform their style-based benchmarks on both an absolute and risk-adjusted basis. Firms that exhibit long tracks records of consistent outperformance (during rolling 1- and 3-year periods) are eligible for further consideration.

This type of analysis is highlighted in the following chart that shows a manager's rolling 3-year ranking in JIC's Large Value Peer Group (ranks closer to one are considered better).

**Rolling 3 Year Return Ranking in JIC's Large Value Peer Group**



This manager's "batting average" would be quite high as it only has a few periods of below-median performance.

Historical portfolio characteristics, growth in assets, low professional turnover, and competitive fees are examples of other factors analyzed. JIC also seeks investment approaches that are understandable, explainable, and consistently applied.

**Ongoing Communication**

On a quarterly basis, JIC will send the following:

- Performance report describing the portfolio's current allocation and performance results.
- A report summarizing current capital market conditions, JIC's current investment strategy, as well as any stocks purchases and sales that have taken place.

JIC is also available for periodic meetings and/or phone calls.

**About Johnston Investment Counsel**

JIC is a privately-owned firm formed in 1997 by Gregory A. Johnston, CFA. JIC provides investment consulting and advisory services to

corporations, defined benefit and contribution plans, endowment and foundations, Taft-Hartley funds and high net JIC is a 100% independent firm whose sole source of compensation is from its client-based fees. JIC conducts its own internal research and evaluation prior to making investment decisions.

JIC has no affiliations and receives no compensation from brokerage, insurance, bank, mutual fund, or other financial-related firms. JIC has no incentive to recommend a specific financial product.

Since JIC has no financial conflicts, our clients can be assured that JIC's advice is always in their best interest. JIC's sole interest is, and always will be, providing our clients with the best possible investment returns consistent with their risk-taking ability.

Gregory A. Johnston, CFA, JIC's President and Chief Investment Officer, has over 15 years of investment consulting and advisory experience. He has earned the prestigious Chartered Financial Analyst (CFA) designation, has a B.A. from the University of Illinois, and a MBA from DePaul University.

To learn more about JIC's defined contribution services please call Greg Johnston, CFA at (309) 674-3330 or go to the JIC website at [www.jicinvest.com](http://www.jicinvest.com).