

# Quarterly NEWSLETTER

Winter 2015



**Commonwealth**  
Bank & Trust Company

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## America Relatively Healthy... Rest of World Ailing...

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After a shaky start in January, U.S. equity markets spent most of 2014 climbing to new highs. Despite two mild pullbacks in July and late September, large cap stocks have yet to undergo a long overdue 10% correction since the beginning of the recovery. Most domestic equity indexes experienced all-time highs at the

beginning of December. The Dow Jones Industrial Average was up 4.58% for the quarter and up 7.52% for the year while the S&P 500 finished the 4th quarter up 4.93% and the year up an impressive 13.68%. Small caps were more volatile during the year, enduring a 13% drop through October before embarking on a remarkable rally late in the year. The Russell 2000 index finished the 4th quarter up 9.73% and the year in positive territory with a return of 4.90%. The NASDAQ, with the strongest performance of the year, finished the quarter up 5.76% and the year up 14.83%. International stocks once again faced many challenges during 2014, ending the year with strikingly different results from domestic equities. The MSCI EAFE finished the quarter at -3.45% and for the year was down -4.20%, while the MSCI Emerging markets index fared slightly better on the year, finishing the quarter at -4.43% and the year at -1.98%. This performance highlights a growing dichotomy between the U.S. economy relative to other major world economies.

Although U.S. economic conditions have strengthened, global economic and geopolitical risks threaten to derail the progress. The European outlook deteriorated throughout the year, with the realities of deflation and GDP contraction materializing during the 4th quarter. The European Central Bank, in response to the ailing economy, lowered key interest rates and recently announced a significant Quantitative Easing program in an effort to spur renewed growth for the Eurozone (see insert for details). Compounding Europe's problems is the worsening financial situation in Russia. The Russian economy is facing financial crisis due to plunging oil prices and sanctions imposed after invading Ukraine. Japan has experienced two quarters of contraction, entering an official recession while China's continued government stimulus calls into question their seemingly strong, though slowing, growth.

As expected, during the 4th quarter of 2014, the Federal Reserve ended its asset purchase program driven by ongoing economic improvement. Mindful of weakness overseas and the possible risks associated with such, the Fed has stated its "patient and data dependent" intention to begin raising short-term interest rates in the second half of 2015. Although the housing recovery has slowed, it continues to improve with existing home prices increasing and new home sales up 2.1% for the year. Robust employment gains pushed the unemployment rate to a multi-year low, finishing the year at 5.8%, which is down 4.2% from its October 2009 high of 10%. Plunging oil prices during 2014 proved to be a benefit to consumers, who have more money to spend elsewhere, as well as companies who are dependent upon fuel, such as airlines, trucking companies, railroads, shippers, etc.

For more in-depth analysis on 2014 results and outlook for 2015, please see the accompanying insert.

Chart 1

Q4 2014 Market Performance – Total Returns			
	12.31.14 Level	Q4	YTD
Dow Jones	17823	4.58%	7.52%
S&P 500	2059	4.93%	13.68%
NASDAQ Composite	4736	5.76%	14.83%
Russell 2000	1205	9.73%	4.90%
S&P Midcap	1452	6.34%	9.74%
Russell 1000 Growth	961	4.78%	13.03%
Russell 1000 Value	1028	4.97%	13.42%
MSCI EAFE	1775	-3.45%	-4.20%
	Yield	Q4	YTD
Barclays Municipal	2.09	0.50%	4.27%
Barclays Aggregate	2.25	1.87%	6.37%
Barclays High Yield	6.61	-1.07%	2.50%

Chart 2

Q4 2014 S&P 500 Sector Performance		
	Q4	Year-to-Date
Healthcare	7.48%	25.34%
Information Technology	5.24%	20.12%
Telecommunication	-4.16%	2.99%
Financials	7.22%	15.18%
Consumer Staples	8.15%	15.98%
Consumer Discretionary	8.74%	9.68%
Materials	-1.80%	6.91%
Industrials	6.74%	9.80%
Utilities	13.19%	28.98%
Energy	-10.68%	-7.79%

### Proprietary Performance Results

	4th Quarter	1 Year	3 Year	5 Year	Since Inception
Focused Equity Fund <sup>2</sup>	5.40%	14.55%	17.52%	15.09%	17.05%
Aggressive Growth Fund <sup>1,3</sup>	9.80%	11.74%	21.07%	16.20%	9.19%
Science/Technology Fund <sup>4</sup>	5.83%	17.26%	20.71%	13.89%	8.38%
S&P 500	4.92%	13.66%	20.34%	15.42%	17.19% <sup>2</sup> , 9.49% <sup>3</sup> , 6.98% <sup>4</sup>
Russell 2000	9.72%	4.89%	19.18%	15.53%	17.24% <sup>2</sup> , 8.18% <sup>3</sup> , 6.85% <sup>4</sup>
MSCI EAFE	-3.46%	-4.22%	11.79%	6.04%	9.86% <sup>2</sup> , 2.13% <sup>3</sup> , 1.70% <sup>4</sup>
Strategic Income Fund <sup>5</sup>	2.44%	10.01%	11.34%	10.42%	11.85%
60% Russell 3000 Val / 40% Barclay Agg	3.88%	10.02%	13.29%	11.16%	11.77%

There is no assurance that any of these investment strategies will meet its investment objective. Performance results for each strategy are computed on the strategy's overall returns. Each strategy and index includes the reinvestment of dividends. Past performance does not guarantee future results. Current performance may be lower or higher than the performance results quoted. <sup>1</sup> Net of management fees; performance results of SMC Capital and/or its principals as advisor from inception to 2/28/06 and as sub-advisors to CBandT since 3/1/06. <sup>2</sup> Inception date 12/31/2008. <sup>3</sup> Inception date 7/1/1989. <sup>4</sup> Inception date 3/31/2006. <sup>5</sup> Inception date 12/31/2008.

## Fixed Income

As expected, the Federal Reserve ended its third round of quantitative easing (QE) announced in Sept. '12. Now the focus shifts to when the Fed will begin raising its fund rate. While the growth outlook for the U.S. is improving, disinflation is probable in the near-term given the dramatic decline in energy prices and the strength of the dollar. Light sweet crude oil futures fell an astounding 42% during the quarter on supply/demand concerns. This will make for a very interesting period given the Fed's dual mandate of maximum employment and price stability (2% inflation target). Speaking of employment, nonfarm payrolls averaged 289k in the 4th quarter vs. 232k year-to-date through September. Currently the consensus is that the funds rate will begin to rise sometime in the second half of '15.

The 4th quarter was a continuation of the yield curve flattening this year with long-term rates declining substantially. For example, the 30-yr Treasury fell by 0.44% to 2.75% & the 10-yr declined by 0.32% to 2.17%. Many were surprised by the bond market strength as predictions were for increasing rates a year ago. We were not surprised by falling rates, though the magnitude is striking. We have previously noted the relative value of U.S. Treasuries vs. other countries, particularly European. That, combined with the appreciating dollar, has fueled demand, particularly from foreign investors. The European Central Bank (ECB) recently announced a sovereign bond purchase program. This has pushed already low rates down further. For example, the German 5-yr Bund ended the year with a 0% yield and has been trading at negative yields.

Again this quarter, global U.S. bond investors were rewarded as the U.S. dollar rose another 5% against other major currencies. The Barclays U.S. aggregate ended the quarter up 1.8% and 6% for 2015. Foreign bonds, particularly emerging markets (EM) performed poorly with local currency

EM hit the hardest. Energy dependent countries such as Russia and Venezuela were impacted dramatically.

The low rate/default environment has benefited the high-yield bond market over a number of years. Earlier this year, we lowered our high-yield asset class ranking/outlook due to valuations. Yet again, our call was validated as investment-grade credit outperformed high-yield with returns of 1.8% vs. -1.0%. We would point out that the energy component of high yield is larger than it has been historically. We raised our outlook to neutral on High Yield given the relative underperformance (High Yield +2.5% '15). Spreads of roughly 5% are about average and we expect that defaults will remain subdued and that "yield" will see growing demand. We also remain neutral on emerging market bonds, though we realize that near term volatility should be expected. We have maintained our ranking for investment-grade & municipal bonds which we consider overvalued. That said, core bond exposure plays an integral role in our balanced portfolios.

Municipal bond returns were stellar, ending the year up 9-10% (1.4% 4Q). Long-term indices (22+ yrs) were up 15.5%. Again, we are not surprised by the recovery, but its intensity. In January we wrote "We believe that the soon- to-be-apparent higher tax rates (including the new 3.8% Medicare Tax) and projected net negative supply should provide some tailwinds this year. In addition, historical yields vs. Treasuries (often converted into ratios) are attractive." We often refer to our portfolio positioning as offensive or defensive particularly from a reinvestment standpoint. Needless to say, we have a defensive bias.

In general, we continue to recommend a tactical underweight to core fixed income in favor of absolute-return-oriented (multi-sector/non-traditional) and other alternative strategies. We anticipate that high yield and emerging market bonds will perform well at some point in '15.

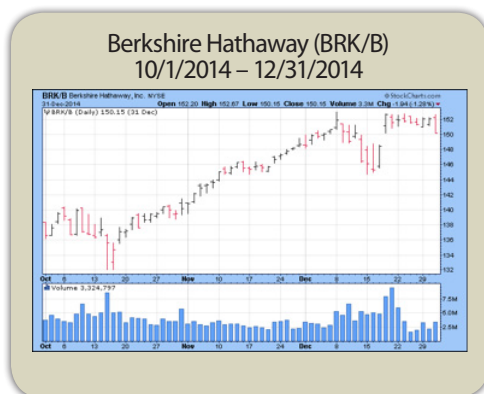
## Focused Equity

For the quarter, the strategy was up 5.40% versus 4.92% for the S&P 500 Equity Index. Since inception, the strategy narrowly trails the benchmark's return of 17.19% by 0.14% with a gain of 17.05%. The return for 2014 of 14.55% beat the 13.65% return for the S&P 500, benefitting from underweight energy, telecom and consumer discretionary stocks. The strategy has a beta of 0.80, so we anticipate that it will lag in strong up markets and outperform in corrections.

Our two largest holdings, Berkshire Hathaway (BRK.B - 7.3% of the portfolio) and Apple (AAPL - 4.7% of the portfolio), made the largest impact in 4Q14 as well as for the year.

Berkshire Hathaway generated a 27% return in 2014 (9% in 4Q14) mostly in the second half after releasing better than expected results in early August. Apple posted a 41% return in 2014 (10% in 4Q14) as it increased margins while generating double digit unit, revenue and earnings growth after introducing its larger screen iPhone 6 and 6+

as well as increasing marketing and distribution in China. Leadership in the portfolio changed a little in the fourth quarter as healthcare companies, Express Scripts (ESRX) and Stryker (SYK) increased 20% and 17%, respectively. Pharmacy Benefits Manager, Express Scripts, benefited from strong earnings and allayed concerns of high Hepatitis C drug costs by negotiating a better deal with AbbVie in December. Top orthopedic device maker, Stryker, rallied into year-end as it beat 3Q14 earnings estimates in October and Republicans announced intentions to roll back the medical device Obamacare tax.



Declines for energy stocks accelerated in 4Q14 and made up 3 of the top 4 laggards as oil prices continued to fall. We are underweight energy (7% vs. 9%) in the portfolio. Collectively, Spectra Energy (SE, -7%), National Oilwell Varco (NOV, -13%) and Schlumberger (SLB, -16%) were only a -0.73% drag on the portfolio. We are repositioning the energy holdings for a bottoming in oil prices later this year. Google (GOOG and GOOGL) shares declined a little over 10% during the quarter as it became more difficult for the company to maintain its high double-digit growth rate as it became larger. We are bullish long term on Google.

## Strategic Income Builder

For the quarter, the strategy was up 2.44%, lagging its blended benchmark return of 3.88%. For the year, it finished right on benchmark with a 10% return. Since inception, the SIB strategy has returned an annualized 11.85%, slightly ahead of its benchmark return of 11.77%. The yield (income) from the strategy has consistently exceeded that of its benchmark, which is comprised of a 60% weighting to the Russell 3000 Value Index and 40% to the Barclay's Aggregate Index. The success of the fund is the result of an attractive mix of income producing securities, exposure to global markets and tactical allocation. Since its inception (1/1/09), the strategy has generated a positive alpha of 1.83% annualized.

Quarterly equity performance of 3.7% compares to 5.3% for the Russell 3000 Value. From an attribution standpoint, this underperformance is roughly split between sector allocation and security selection. A significant underweight in financials (+7.8%) & a slight overweight in energy (-10.1%) was most costly from an allocation standpoint.

Our selection within energy more than offset this slight overweight. Kinder Morgan (KMI) was up 11.6% for the quarter. In November, KMI completed its acquisition of the outstanding equity securities of Kinder Morgan Energy Partners, L.P. (KMP), Kinder Morgan Management, LLC (KMR) and El Paso Pipeline Partners, L.P. (EPB).

Consumer Staples (+10.3%) was most costly from a selection standpoint. PepsiCo (PEP) which is not in the Russell 3000 Value was up only 2.3% for the quarter, though it ended the year up 17.3%. In addition, Philip Morris International (PM) was down 1.1% for the quarter and 2.1% on the year. Recent headwinds include declining volumes and cost increases. In September, PM increased its quarterly dividend to \$1 a share from \$0.94 representing a 6.4% increase. Also, the new payout ratio is closer to the 75%-80% range, which is higher than historical trends but makes for an attractive 4.8% yield. We are willing to accept lower growth prospects with higher yields such as this.

Taxable fixed income (+0.3%), tax-free (+0.4%) & alternative positions (-4.0%) weighed on quarterly performance vs. the Barclays Aggregate (+1.9%). Templeton Global Bond Fund (-1.7%) & T Rowe Price Institutional Emerging Markets Bond (-1.5%) also pulled performance down as foreign bonds struggled. In addition, T. Rowe Price High Yield Fund (-1.8%) significantly lagged the investment grade benchmark. We note that energy has been a growing component within high yield.

PIMCO All Asset All Authority (PAUIX -4.5%) & PIMCO All Asset Fund (-2.9%) managed by Rob Arnott of Research Affiliates are alternative positions within the strategy. These funds allocate to sectors that do well during periods of inflation such as high yield and emerging markets. This year and particularly the quarter was one of falling inflation expectations given the declining oil and commodity prices. Over time, these positions are expected to reduce overall portfolio volatility.

## Science & Technology Strategy

The Science & Technology (SciTech) strategy's 5.83% 4Q14 return outperformed the S&P Information Technology and Telecom sector results of 5.24% and -4.16%, respectively, but was below the Healthcare sector return of 7.48%. SciTech beat the Nasdaq 100 and the broader Nasdaq Composite returns of 4.97% and 5.75%, respectively. The Science and Technology solidly beat its closest benchmark proxy, the Lipper Science & Technology index, which was up 5.05% for 4Q14. For 2014, SciTech returned 17.26% vs. 19.46% for the Nasdaq 100, 14.81% for the Nasdaq Composite and 12.26% for the Lipper Science & Technology index.

Neither the Nasdaq 100 index nor the Nasdaq Composite is a pure-play technology index as consumer product companies comprise about 15% of the Nasdaq 100 and about 20% of the Nasdaq Composite, while the Composite also has about 7% allocated to financials. A little over 90% of the difference in performance for the YTD period and over 100% of the difference for the 12 month period was a lower allocation in the Sci Tech fund vs. the Nasdaq 100 to Apple (9% vs. 13%) and Microsoft (2% vs. 8%). Both stocks are up over 25% YTD and over 40% for the 12 month period.

Leaders: French ADR, Criteo (CRTL), rebounded 16% during 4Q14 as this company proves to be the top platform for advertising agencies to place on-line ads intelligently targeted to consumers. Cyber security holdings, Palo Alto Networks (PANW) and Proofpoint (PFPT) both soared over 20% in the quarter in response to positive earnings and disclosure of the Sony hack, among others. Palo Alto Network's 88% return made it the top contributor for 2014 performance. The portfolio benefited from healthcare acquisitions involving Actavis (ACT +21%), Covidien (COV +21%) and Intermune (ITMN +44%) during 2014.

Laggards: Our small position in leading 3D printing company, Stratasys (SSYS), fell 35% during the quarter, on the news that Hewlett Packard (HPQ) announced it would

introduce a 3D printer in 2016. We trimmed the position to harvest tax losses, but we will likely add to this position at the lower price, since we believe Stratasys has a lead on HP. Aerospace alloy producer, Precision Castparts (PCP -11%), experienced a perfect storm of a stronger dollar, weak European demand and a drop in sales to the oil patch. We are trimming PCP as we expect the company to face headwinds for much of 2015. Stratasys and Precision Castparts were also our biggest laggards for 2014, falling 63% and 34%, respectively.

## Small Cap Composite

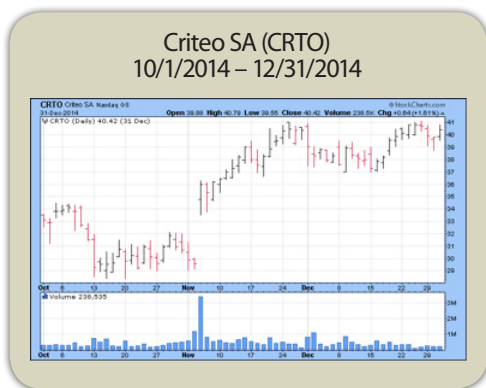
The Small Cap Value Composite returned 6.25% for the fourth quarter and 0.87% for the full year 2014, versus a fourth quarter return of 9.73% and a 2014 return of 4.89% for the Russell 2000 index.

One top contributing holding in the Portfolio during Q4 was Ingles Markets Inc. (CI A) (IMKTA), a regional grocery chain with 202 stores in the Southeastern United States. Since establishing the position, management has consistently delivered strong operating results and its recent Q4 report was no exception. The surge in the share price was likely attributable to rumors that the company is open to selling itself to a larger strategic player,

as well as a tailwind in the broader Consumer Staples sector. Another top contributor during Q4 was UniFirst Corp. (UNF, +26%), the third largest provider of workplace uniforms in North America. UNF reported Q4 results above expectations driven by a 17th straight quarter of positive year-over-year organic growth for the core laundry business. The stock received another

boost in mid-December when competitor Cintas reported strong quarterly results driven by organic growth in its uniform rentals business. Another positive contributor during the quarter was SP Plus Corp. (SP, +33%). As the largest provider of parking facility management services in the United States, SP runs the day-to-day operations for customers in exchange for a flat monthly fee that is not dependent on volume. In early November, SP announced Q3 results that were in line with our expectations. Much of SP's share outperformance occurred in December and was likely tied to the market's rewarding the company's stable operating characteristics. We took no action on the position.

A large negative contributor to performance in Q4 was Miller Energy Resources Inc. (MILL), an independent oil and gas exploration and production company with operations in the Cook Inlet Basin and North Slope of Alaska. Despite receiving an improved third-party reserve report during Q3, Miller reported disappointing results from a high-potential offshore oil well. Miller's problems were compounded after OPEC's November decision to maintain production quotas sent oil prices sharply lower. Another poor performer during the quarter was TETRA Technologies Inc. (TTI, -38%), an oil and gas service company. TTI reported surprisingly weak performance from the Offshore Services business, driven by intense competition and customer project delays. The significant energy price decline also weighed heavily as TTI customers are likely to cut capital spending budgets and negotiate lower pricing for services. We trimmed our position during the quarter. Rounding out the bottom three contributors, wireless phone provider NTELOS Holdings Corp. (NTLS, -61%) announced its decision to exit its eastern market, where it competed with all of the major wireless carriers. While we agree this is the right move strategically for the company, we underestimated the negative impact it would have on its western operations. By shutting down the eastern market, the company's fixed costs will now be fully absorbed by its western operation and will reduce profitability. Given the position's small size, we took no strategic action during the quarter.



## Kentucky Municipals

Fourth quarter bond issuance by Kentucky municipalities increased to \$694 million from \$359 million (65 issues). New issue size averaged a reasonable \$10.7 million. Non-BQ (bank qualified) issuance was \$394 million or 57% with BQ issuance of \$146 million or 21%. For our clients, we tend to utilize non-BQ because yields are typically higher. Taxable issuance was \$84 million or 12%. There was \$70 million of AMT-subject issuance during the quarter. We are purchasing more of these bonds as our typical client is not impacted by the alternative minimum tax (AMT) and yields are typically higher for a given maturity. Visible supply for coming months is strong at \$507 million. State Property and Buildings Commission (Aa3/A+) is on the calendar with a \$389 million deal slated for January. Given the drop in rates, many of the deals are to refinance (refund) existing debt. One portfolio strategy we use is to purchase refunding candidates. This is especially the case during defensive posturing.

During the quarter, our 10-year Kentucky tax-exempt yield target fell 0.2% to 2.55%. Our 15-year yield target fell 0.2% to 3.05% during the quarter.

Bloomberg provided an update on state pensions. For the fourth year in a row, Illinois, Kentucky and Connecticut top the list of most underfunded pension plans. KY's funding ratio (combined) declined to 44.2% from 46.8%. This is in contrast to the national median rising to 69.3% from 68.7%. For reference, Illinois fell to 39.3% from 40.4% while Connecticut remained steady at 49.1%. It is important to note that for now there is no penalty (additional spread/yield) in the KY market vs. comparably rated bonds. Illinois is penalized within the marketplace and trades at higher yields than similarly rated bonds.

A 15.5% return in fiscal 2014 wasn't enough to bolster the Kentucky Employees Retirement System. Officials shortchanged the plan for more than a decade leaving KERS with 21% of the funds needed to pay promised benefits in 2014 as distributions exceeded revenue. No single state plan has a lower ratio, according to the Center for Retirement Research at Boston College.

In 2013, lawmakers passed steps designed to cut the expense of KY's plans by moving future workers into a type of plan that doesn't promise specific benefits. They also limited cost-of-living increases. In 2015 and beyond, KY has committed to make full payments. If it receives that money and earns its 7.5% estimated return, its funding ratio may still shrink to as low as 15%, though it will climb back to 100% over 30 years according to William Thielen, executive director of KY Retirement Systems. The strategy "will work — if we don't neglect it or negate it," Governor Steve Beshear said in his State of the Commonwealth address on Jan. 7. We reiterate that pension issues are longer-term challenges though we are diligent in diversification.

We continue to think intermediate bonds are the most attractive part of the market, particularly given recent curve changes. Our bias remains for using defensive coupons of 4% or greater with a focus on premium callable municipals sometimes referred to as "cushion" or "kicker" bonds. Our performance themes continue to evolve around "rolling the steep yield curve" and opportunistic buying/selling within a somewhat volatile market. We continue to evaluate portfolio positioning, balancing risk/reward in a manner that is consistent with our longer-term philosophy and each client's objectives.

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