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There is never a shortage of things to worry about with the Euro zone debt situation still unresolved as German Chancellor Angela Merkel leads the effort to finalize a 2nd Greek bailout. Italy has passed reforms, but their 10-year bond yield is still over 7% as the market digests the news. There will likely be more fallout in the region as the ultimate solution to their fiscal imbalances remains elusive. Domestically, the economy continues to slowly mend from the great recession. The Labor Department recently reported that the unemployment rate has dropped to 8.5%, and there has also been positive improvement in manufacturing numbers. As always we will closely monitor the upcoming quarterly earnings announcements to gauge the strength of the recovery and confirm that our holdings are on track.

The Presidential primary season is heating up with Mitt Romney establishing a solid lead as the Republican front runner. It's doubtful that Congress will pass any meaningful legislation before the November election, preferring to kick the can down the road. They did manage to extend the 2% payroll tax cut for 2012. This short sighted action increases the strain on the social security trust fund as the worker to retiree ratio continues to decline.

I am happy to report that despite a few twists and turns, the rate of return for our average client account closed out a third consecutive year in the green. Our balanced risk-sensitive approach delivered an average return across all client accounts of 3.74% for the quarter, and 3.03% for 2011, net of management fees and Schwab costs. My associate, Warren Isenberg and I continue to focus more on selection than timing, having learned the hard way that it's easy to sell, but markets have a way of shooting higher when least expected, so you always want to keep some skin in the game. We will sell a position when our target price is reached, or when new information comes out that is not well received and we want to protect a profit or cut a loss. We are long-term believers in the U.S. economy and our free enterprise system with the dollar maintaining its status as the reserve currency of the world. So we continue to focus the majority of our holdings in U.S. dollar denominated securities. Owning common stock in strong well-financed companies gives us the opportunity to participate in the growth of corporate profits, dividends, and share prices. It's been a long time since with the dividend yield on the S&P 500 (2.1%) ended the year higher than 10 year Treasury bonds (1.88%), showing the relative appeal of stocks.

Strategy – Confirm that your cash flows are secure and that you can comfortably meet your expenses for the next 3-5 years. Maintain a well-constructed portfolio that allows you to sleep well at night. If you are not working or are in the latter stages of your career, a higher degree of safety is important with 50% or more in fixed-income securities and cash. Hold quality dividend-paying stocks across different industries for a growing income stream and capital appreciation. Hold select bonds and bond funds for diversification and regular income. With negative real interest rates and continued geopolitical risk, a small position in the **SPDR Gold Trust** makes sense, but after 11 consecutive up years, caution is warranted. Keep 5 - 15% in cash for emergencies and dry powder to take advantage of bargains.

Remember to be leery of chasing past performance, and that some of the best opportunities for new money may be found amongst the poorer performing areas from last year.

Fixed-Income – Bonds , Funds, & Preferred Stocks – We own both individual bonds and bond funds for safety and steady income. Splitting our exposure between individual bonds and bond funds provides the best of both worlds. Individual bonds have the certainty of semi-annual interest payments with a return of principal on the maturity date. Bond funds provide broader diversification and more frequent cash flow with monthly or quarterly dividends.

In general bond prices had a terrific year in 2011, riding a tail wind of lower market interest rates. Higher quality domestic bonds (Treasuries, corporates, and municipals) topped the charts. Inflation expectations are currently muted and global capital flows have favored U.S. Treasuries, but we are reluctant to chase prices hovering near all-time highs, and are not betting on lower long-term interest rates in the years ahead.

It is a challenging environment to make money with the Fed keeping short-term interest rates anchored near zero and having stated no desire to raise rates until mid-2013 at the earliest. Our largest fixed-income holding is the **Doubleline Total Return Bond Fund** (DBLTX). The fund continues to mine the secondary market for discounted mortgage-backed securities and posted a total return of 9.51% for 2011. Jeffrey Gundlach captains this no-load juggernaut based in Los Angeles. The **Templeton Global Bond Fund** was a disappointment last year, but we are committing more capital at these lower levels and closely monitoring the share price for any additional deterioration. For our more risk tolerant accounts we bought back into the **Templeton Emerging Markets Income** (TEI) closed-end fund. This non-leveraged fund is racier than its open-end cousin and pays a quarterly dividend with a 6.4% annualized yield.

Preferred Stocks are a hybrid security designed to provide a higher yield than a bond and more stability than common stock. We own a floating rate preferred from **Goldman Sachs** (GS+A) to hedge against higher long-term interest rates. We also purchased a deeply discounted fixed-rate preferred from **Ally Financial** (ALLY+B) last quarter. This rebranded company is the old GMAC, and with the U.S. government owning 70% of the company, default risk is not a concern.

Tax-Exempt Municipal Bonds – A year ago the sky was falling in muni land with fear rampant about municipal revenue shortfalls and a guru's prediction on "60 Minutes" of billions in defaults coming due to fiscal imbalances. We chose to ignore the doomsday scenario and increase our exposure at bargain levels via numerous individual issues, and the **American Century CA High Yield Municipal Fund**. Between dividends and price appreciation, the fund was up 11% last year. Many municipalities have made adjustments and cut expenses, while revenue is slowly coming back as the economy creeps forward and housing prices bottom out. We are avoiding State of California bonds and prefer to own bonds issued to finance more local projects, many of which are located in Orange County. Water revenue, general obligation, and special tax land-backed bonds have all worked out well and moved higher in price. The tax-free interest from municipal bonds will become more valuable with a new 3.8% investment surtax scheduled to begin in 2013 to help pay for Obamacare.

Equities – Please note that your holdings may not include all securities discussed due to different client start dates and stock price patterns. Our best gains last year came from specialty retailers

Pricesmart, **Starbucks**, and **Buckle**. On the other hand, **Target** performed poorly and has been sold following weak holiday numbers as they continue to lose market share to Amazon. Boring utilities were strong and we participated with **Nextera Energy** and **Sempra Energy**, while **Exelon** and **NRG Energy** lagged. Nextera was sold last quarter to nail down a gain after the company missed revenue and earnings estimates. Big oil majors **Chevron** and **Exxon Mobil** rallied and increased dividends with the price of oil topping $100/barrel amid rising international tensions. **Ultra Petroleum**, an independent producer focused on natural gas fell victim to a weak pricing environment and increased regulatory scrutiny around hydraulic fracking. It may be many years before increased supplies are worked off and pricing improves.so are looking to exit on an uptick and move on.

Technology companies **Apple**, **Google**, **IBM**, and **Qualcomm** all posted solid gains for 2011 as consumers and business customers continue to spend on information technology to access data at faster speeds via the cloud and mobile internet. Smart phones and tablets continue to gain market share. We did sell the majority of our Google shares after the first of the year to protect our profit following a big 4th quarter surge and seeing the stock turn lower on heavy volume following some disturbing news regarding a 4th quarter revenue shortfall from Motorola Mobility, which is a $12.5 billion acquisition target of Google awaiting regulatory approval. We would certainly consider buying the shares back at a lower price.

Industrials struggled last year following big gains in 2009 & '10, but we are sticking with Dow component **Dupont** for their global prowess, reasonable valuation, and 3.5% dividend yield. We added a new position last quarter in **Xylem, Inc**. Xylem was spun off from ITT Corp. in October and is a pure play water infrastructure company. Our aim is to capitalize on the replacement market in developed countries and new installations in emerging markets, which currently account for only 18% of sales.

Financials, especially big banks, were in the cellar last year, but have suddenly caught fire since the calendar turned over. We believe in reversion to the mean and the valuations on the banks are extremely compelling. The housing and mortgage debacle along with the rules imposed by Dodd Frank have been priced in and the markets are sensing that maybe the 4th quarter just passed will be the low water mark. We own **JP Morgan Chase**, **Wells Fargo**, and have established a new position in **Bank of America** which has tumbled the farthest, and holds the best rebound potential moving forward. The company has aggressively cut costs, and sold assets to bolster capital levels. **Berkshire Hathaway**, with their large insurance operations has also struggled and represents excellent value. Asset manager, **Franklin Resources** was sold following news of asset outflows from their flagship Templeton Global Bond and the firm's refusal to offer lower cost ETF's. We are content to continue to hold the bond fund for the 5.1% yield and recovery prospects, but chose to exit the higher risk stock of the management company.

International Equity Funds – We typically hold 5-10% of a portfolio in this area to take advantage of the higher economic growth rates in the emerging markets. We have avoided Europe and instead concentrated our holdings in the **Matthews** family of funds for their focus on the Asia Pacific region. All foreign markets struggled last year, so now is an excellent time to dollar cost average some additional money in, assuming one is comfortable with their inherent higher volatility. The **Ishares Msci Emerging Markets ETF** (EEM) is another good vehicle to play this long-term theme.

Time to Refinance – Mortgage interest rates have continued to drop to record low levels. Yes it's a hassle to deal with, and yes it costs some money to go through the process (even with the costs wrapped into the new loan), but if you plan on staying put for the next several years and you can reduce your note rate by 1% or more, there could be thousands of $$ in interest savings available to you by acting now. We would recommend locking in a fixed rate fully amortized loan over the shortest period that you can comfortably afford. Certain lenders are now offering 10 or 15-year fixed rate loans in the 3% range with low or no points. A high FICO score is key, along with equity in the property and full documentation of sufficient income. Working with a trusted mortgage broker is fine, or if you are motivated to do more work yourself, visit www.amerisave.com, a direct internet lender with very competitive rates & terms.

Estate Planning – A new year is a good time to review your estate plan. A revocable living trust remains essential to avoid the costs, delays and public nature of probate. A pour-over will along with durable powers of attorney for health care and property are standard. If your documents haven't been reviewed in a few years, it's probably time. Also, a quick check of beneficiary designations for retirement accounts and life insurance is wise.

For 2012, individuals may gift up to $13,000 per person with no tax ramifications for the donor or donee. In addition, there is a $5.12 million individual estate & gift tax exemption that is scheduled to decline in 2013, so for older clients with larger estates it's a prime opportunity to implement advanced gifting strategies. We would be happy to have a review meeting with you and your successor trustee or beneficiaries when appropriate. If you are happy with your estate attorney, please let us know as we are always looking to expand our network of allied professionals.

If you have any questions or comments regarding your portfolio, or any recent changes in your health or financial situation, please let us know. If you have not come in for a review session lately, feel free to call or email and schedule an appointment so we can catch up. Thank you for your continued trust and confidence, we appreciate it.

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