Investments & Wealth Management January, 2014

By: Scott Walker, CFP®

I hope this finds you in good health so you have the ability to enjoy your money and live life to the fullest this year. We are settled into our new offices in the Schwab building and invite you to come by for a visit and catch up. Our conservative balanced strategy held us back last year, but provides downside protection and peace of mind for your hard earned capital. The 10-year U. S. Treasury bond yield ended the year at 3.04%, up over 1% last year. We continue to recommend holding a diversified portfolio of high quality individual issues (dividend-paying common stocks & bonds), along with low-cost ETF's and a few managed mutual funds. Our goal is not to beat the stock market, but rather to preserve wealth, minimize taxes, and avoid large losses. Interest and dividends constitute an important part of our total returns. See pages 2 & 3 of your quarterly report to view your investment gain and net performance numbers.

Income Tax Savings – Health Savings Accounts (HSA's) are likely to gain in popularity for those able to handle a high deductible health insurance plan and not covered under an employer plan. Family max HSA contribution for 2014 is $6,550, plus $1,000 catch up if age 55. There is a minimum $2,500 deductible on the insurance. Contributions to the HSA are pre-tax and adjusted out of taxable income each year. Plan reimbursements are paid tax free to you. Withdrawals must be for health care expenses or penalties apply. HSA contributions are not allowed once you reach age 65.

Common Stocks – Please note that your holdings may not include all securities discussed due to different client start dates and stock price trends. The fundamental backdrop for stocks remains positive but valuations are currently stretched for many issues, so we are treading cautiously finding fewer bargains. A period of consolidation would not be unexpected given the large advance last year, but for now the uptrend is intact. Dividends have room to move higher given that payout ratios are historically low, with most S&P 500 companies flush with cash. We will be monitoring upcoming company quarterly earnings reports to confirm our holdings are on track. Here's a summary of our largest holdings by sector:

Energy – Although oil prices have moderated lately, we continue to hold and like the two biggest integrated U.S. based majors – **Chevron** and **Exxon Mobil**. These two stalwarts have operations across the globe that includes not only oil exploration and production but also significant operations in natural gas and renewable energy alternatives. Both companies have a long history of annual dividend increases. Current dividend yields respectively – 3.2%, 2.5% (All current yields are as of 12/31/13). Last quarter **Berkshire Hathaway** disclosed a new stake in Exxon.

Financials – One of the top performing sectors for the past two years. The big banks are finally settling lawsuits from the credit crises which eases the uncertainty about future charge offs.

Higher interest rates help margins. We own **Wells Fargo & Co.** but are reluctant to buy more at today's price. Current dividend yield – 2.6%. Berkshire Hathaway owns GEICO and 14% of the common stock of American Express Co. **WisdomTree Investments** is a new holding that is the investment adviser to a unique ETF family. We also own their small cap dividend ETF. No dividend, and It trades at a high price multiple, but has the growth in revenue and earnings to back it up.

Health Care – This was the top performing sector in 2013. A new position was established last summer in **Abbvie, Inc**. This is a spin off from Abbott Labs that began trading independently a year ago. Humira is their big drug for rheumatoid arthritis along with a rich pipeline, with 10 studies in phase III. Current dividend yield is 3.0%. We took profits and sold Actavis and Eli Lily.

Industrials / Materials –Construction equipment titan **Caterpillar** brought up the rear in the Dow 30 last year as lower sales to emerging markets hurt results. We think the bad news is priced into the stock and expect the 4^{th} quarter momentum to continue moving forward. Current yield is 2.6%. **Dupont** is riding the construction boom with their insulation and building materials business. The stock was our top performer for the year with a 49% gain including dividends. Current yield is 2.8%.

Real Estate – The housing recovery kicked into high gear last year with prices jumping as buyers scrambled to get in before mortgage rates go higher. After a stellar 2012, **Lennar Corp.** treaded water last year but is positioned to profit as the recovery continues to mature. The Miami based company has projects in 18 states across the U.S. including six different projects in Irvine.

Retail – **Nordstrom, Inc**. posted a good year as higher end consumers spent more freely now that the economy is on firmer ground. Residual positions in **Costco Wholesale** and **Starbucks** also did well. **The Buckle, Inc**. has gotten crushed lately so we are looking to add more shares of this Kearney, NE youth apparel company. Management owns 42% of shares outstanding. Current yield is 1.9% plus a history of special year-end dividends.

Technology – San Diego based **Qualcomm Inc.** has a mission is to deliver the world's most innovative wireless solutions. The company is the largest fabless semiconductor manufacturer in the world, and also licenses their technology which produces a high margin royalty stream of revenue. Fundamentals are rock solid with 33% revenue growth last quarter, growing earnings, no debt, and a 1.9% dividend yield. Cloud computing continues to grow since companies can save money by paying a lower monthly fee for "software as a service", as opposed to a large initial capital outlay and annual license renewal fees. The "cloud" refers to an offsite data center where software applications and data are securely stored and may be accessed from any location via an internet connection. **IBM** is a major cloud player that provides IT consulting services for institutions and governments worldwide. The company was a Dow 30 laggard last year under new CEO Ginny Rometty and represents the best blue chip turnaround prospect for 2014.

Utilities – **Sempra Energy** was a standout performer last year. Besides owning SDG&E and S. CA Gas Co., they operate one of the largest photovoltaic solar facilities in the U.S., and have two liquefied natural gas (LNG) terminals up and running. Current yield is 2.8%. **AT&T** and **Verizon Communications** are the two heavyweights in telecommunications. Both continue to upgrade their wireless networks to accommodate more smart phones and tablets. We don't expect much share price growth from these behemoths, but do expect both to continue their history of annual dividend increases. Current yields are 5.1% for AT&T, and 4.3% for Verizon.

Equity Exchange-Traded Funds (ETF's) – These low-cost passively managed index products continue to gain market share. We own shares in the **SPDR Dividend ETF** which tracks the S&P High Yield Dividend Aristocrats index. It is comprised of 84 stocks that have increased dividends annually for at least the past 20 years (current dividend yield 2.6%). Last year we also established a position in the **WisdomTree SmallCap Dividend Fund**. This ETF has 25% in financials and pays monthly with a 2.5% current yield.

International Stock Funds – For more risk tolerant accounts we added the **iShares MSCI South Korea ETF** last summer. This ETF owns the biggest companies traded in Korea including Samsung Electronics, Hyundai Motors, and LG Electronics. The ride doesn't get much smoother than with the **Matthews Asian Growth & Income Fund**. We get direct exposure to the most dynamic growth region in the world, but with a conservative tilt. The current dividend yield of 2.3% represents a small part of the total returns we have enjoyed with this fund.

REIT's – Real estate investment trusts or REIT's struggled last year as their sensitivity to interest rates became clear. Prices fell off a cliff in May, but have stabilized recently. REIT's are known for their lush dividends as 90% of net income goes to shareholders to avoid tax at the corporate level. We own Escondido, CA based **Realty Income** in this space. The company issues equity and debt to fund all cash purchases of commercial real estate. Tenants sign triple net leases where they pay for taxes, maintenance, and insurance. The resulting cash flow is paid out to shareholders in a monthly dividend. The current yield is 5.8%. During 2012, 25% of the payout was return of capital.

Fixed-Income Investments - We own both individual bonds and bond funds for safety and steady income. Individual bonds have the certainty of daily interest accrual, semi-annual interest payments, and a return of principal on the maturity date. Bond funds and ETF's are more liquid, provide broader diversification, and higher current yields. The Federal Reserve threw cold water on the bond party last May with an announcement that they would consider tapering monetary policy later in the year. The Fed has been buying $85 billion per month of long-term Treasury bonds and mortgage-backed securities to lube the economy and keep borrowing costs low. The plan is to reduce the asset purchases by $10 billion per month beginning this January.

Bond Funds / ETF's – Our largest positions are now concentrated at the short-end of the yield curve. The **Powershares Senior Loan ETF** and **Pimco 0 – 5 Year High Yield Corporate Bond ETF** are defensive shorter-duration holdings with current yields in the 4% range.

We have also added three new multi-sector bond funds that give the managers the flexibility to invest wherever they find the best value in an unconstrained manner. The most conservative is the **Loomis Sayles Strategic Income Fund.** Skippered by Dan Fuss, the fund is defensively positioned against rising rates with a four year duration. Holding high yield and emerging market bonds allows the fund to pay out 5.1%.

Small new positions have also been established in the **Pimco Dynamic Income Fund** and the **Doubleline Income Solutions Fund**. These are both closed-end funds that are trading at a discount to net asset value. They are higher risk vehicles that employ leverage to boost the current yields to 7%+. We do not expect the Fed to raise short-term interest rates until 2016, so we are comfortable with leverage for the time being.

Emerging Market bonds lagged last year, so we picked up the largest ETF in the space well off its 52-week high. The **iShares J.P. Morgan USD Emerging Markets Bond ETF** is the low-cost way to access this asset class. This ETF has over 200 holdings with Russia, Brazil and Mexico representing the top three countries. We view this ETF as a lower risk vehicle to participate in the economic growth of the emerging markets. Current yield is 4.6%.

Tax-Exempt Municipal Bonds – It has been slim pickings for new issue municipal bonds with very low yields. We are not willing to extend maturities to reach for yield and accept higher interest rate risk. The best current option is the **American Century CA High Yield Municipal Fund**. This fund has historically been less interest rate sensitive than investment grade funds. It pays a monthly dividend and sports a 4.3% tax-exempt yield. We continue to hold many water revenue, general obligation, and special tax land-backed bonds. Muni bond demand has been steady since the tax-free interest is exempt from the 3.8% investment surtax that now hits high bracket taxpayers.

Estate Planning – For 2014, individuals may gift up to $14,000 per person with no tax ramifications for the donor or recipient. For larger estates, there is a $5.34 million estate & gift tax exemption per person this year. An executor can elect to allocate the unused portion of a decedent's exclusion amount to the surviving spouse with a portability election.

If you have any questions or comments regarding your portfolio, or any recent changes in your health or financial situation, please let us know. Thank you for your continued trust and confidence, we appreciate it.

January 15, 2014