Review, Outlook and Opinion ______________ April, 2008

By: Scott Walker, CFP

Where's the Bottom? – It has been a long hard winter with stock prices world wide getting hammered. High quality preferred stocks, bonds, and cash have been the place to be as the flight to safety continued last quarter. For many accounts, especially those with monthly withdrawal or annual distribution needs, we have been 10-20% in cash, which has cushioned the down draft. Warren and I clearly underestimated the extent of the recent decline in the equity markets. The S&P 500 stock index closed down 9.9% for the quarter, while our average client account was down 4.6%. This has been painful, but we see it as a temporary decline in value, not a permanent impairment of capital. Our accounts have been moving higher since the low on March 20, as the trend has turned up for equity markets and most of our holdings.

The Federal Reserve Board and Mr. Bernanke have been working overtime due to the housing induced credit crunch. As the value of mortgage-related securities continues to crumble, financial institutions with leveraged exposure in this area faced margin calls. This means there was a loan from an investment bank, like JP Morgan Chase, to a brokerage firm like Bear Stearns. Bear Stearns then invested the money in high yielding sub-prime mortgage backed securities. People stopped paying, defaults occurred, and the mortgage securities were marked down substantially in price. Bear Stearns can't meet the margin call, so with the help of the Fed, JP Morgan acquires Bear Stearns at $10 share.

The Fed has been extremely accommodative lately with multiple rate cuts including a huge 0.75% one-time reduction in order to stimulate the economy. The Fed funds rate now stands at 2 ¼ %, with expectations of another ¼% cut at the April 30th meeting. Treasury yields have plunged to 3.43% on the 10-year note, and a whopping 1.47% for a 6-month T-bill. There is no reason to buy into this over valued area today. Lower interest rates will be a tail wind for equities once credit conditions normalize.

The unwinding of the housing bubble and mortgage mess continues. In most areas, residential property values have dropped by 10 - 20% since the high two years ago. The last real estate downturn began in 1990 and lasted through 1996, so a quick turn around in home prices this time around is very questionable. It's all about location and buying at a reasonable price with modest leverage.

What to do Now? – A client recently inquired: "The monthly changes in my account value have gotten larger, should I be concerned?" Informed yes, but concerned no. The markets have been unusually volatile over the past five months, but our balanced accounts have declined by about one-half as much as the stock market. Hang in there and resist the urge to sell. It's easy to pull the plug and sell, but no one rings a bell at the bottom, and market rallies tend to occur when investors are most pessimistic. No one has amassed a fortune over the years as a market timer. Time, not timing is the key to compounding returns and building wealth. Maintaining a balanced posture with both equities for growth and fixed-income securities for safety and income is the best way to handle risk.

Stock Funds – A recent new pick for us is **Janus Adviser Forty**, Class I (JCAPX). This concentrated offering is modeled after the **Janus Twenty Fund**, which is currently closed to new investors. This fund is not for the faint of heart, but will deliver the goods when stocks rally. It is managed by Ron Sachs, a Chartered Financial Analyst, who has been with Janus since 1996. He is assisted by a deep bench of research analysts. Foreign stocks comprise 37% of the fund. Top holdings include Google, Research In Motion, Potash Corp. Saskatchewan, and Intuitive Surgical. Other large cap funds we continue to hold are **Vanguard Primecap**, **Vanguard Primecap Core**, and **American Funds Fundamental Investors**.

International stock funds also declined in price during the first quarter, but the **First Eagle Overseas** Fund held up much better than most with only a -1.86% decline. Unable to find many bargains after five years of rising stock prices, portfolio manager Jean-Marie Eveillard's had let cash build up, and he also maintains a portion of the fund in gold bullion and gold related securities as insurance. The fund has been making recent purchases in Japan.

Exchange-Traded Funds (ETF's) – These baskets of securities are designed to replicate an index, and carry lower expenses than actively managed funds along with excellent tax efficiency. They trade throughout the day on an exchange, unlike standard mutual funds which price at the end of each day. We pay Schwab an equity trading commission to buy and sell ETF's, just like an individual stock. For larger accounts, we will use them to supplement our core actively managed mutual funds. They come in all varieties, but we prefer those that target a specific industry sector. They provide more pop than broadly diversified funds, but carry less risk than individual common stocks. The market sell off last quarter gave the opportunity to add to the **Energy Select Sector SPDR** (XLE). We also have purchased the **United States Natural Gas Fund** (UNG), and did some bottom fishing with the **SPDR S&P Homebuilders** (XHB), **SPDR KBW Regional Banking** (KRE), and **iShares Cohen & Steers Realty Majors** (ICF) . We believe that businesses will continue to spend on technology to improve productivity, so we bought **iShares Goldman Sachs Semiconductor** (IGW) and **iShares S&P GSTI Software** (IGV).

Common Stock Spotlight – Can you name one of the largest companies in America whose slogan is: We bring good things to life? The answer is **General Electric Co.**, one of the largest and most diversified industrial companies in the world. Their business segments include power plant infrastructure, medical imaging, jet engines, NBC Universal, and commercial finance. Foreign sales represented 87% of the $172 billion total for 2007. We've owned this stock for awhile, but last quarter we noticed that CEO Jeffrey Immelt made a sizable open market purchase, so we increased our position. At the current price of $37.01, the stock sports a 3.3% dividend yield and management has increased the dividend annually for the past 31 consecutive years.

Preferred Stocks – The majority of our preferreds moved higher in price last quarter. We established a new position in **National Retail Properties**, Class C 7.375% (NNN+C). With the weakness in the real estate sector, this issue traded down to an attractive entry point for us. National Retail is a real estate investment trust (REIT) and was formerly known as Commercial Net Lease Realty. We owned a preferred issue from them in the past that was called away at $25/share par value. The firm maintains a conservatively managed, diversified real estate portfolio with properties subject to long-term net leases with established tenants. They own over 900 properties in 44 states. The properties are leased to 198 tenants in 35 industry classifications, with current occupancy of 98.3% and an average remaining lease term of more than 13 years.

<u>Closed-end Income Funds</u> – Global High Income Fund (GHI) continues to be our favorite in this area. We view this emerging markets bond fund as a lower risk way to play the growth in developing economies. Unlike most closed-end funds, this one typically trades at a premium to net asset value. This fund ended the quarter with a positive total return of 4.88%, and a current dividend yield of 9.3%.

<u>Bonds / Bond Funds</u> – A soft economy, contained inflation, and the flight to safety benefited our investment grade bonds last quarter, but it's tough to get excited about committing any fresh dollars at the current high prices and low yields. However, with money market yields heading lower we have been reallocating some cash into three bond funds that pay reasonable monthly dividends. The **Vanguard Short-Term Investment-Grade** (VFSTX) holds plain vanilla high quality U.S. bonds with Vanguard's trademark low costs. This is one step past a money market fund, so we expect very mild fluctuation in the share price. Current distribution rate: 4.8%. The **Metropolitan West Total Return Bond Fund** is a core U.S. intermediate-term bond fund, and an old favorite of ours. Based in Santa Monica, the managers learned the trade working with Bill Gross at Pimco. Current distribution rate: 5%. The **Loomis Sayles Bond Fund** (LSBDX) is the most aggressive of the three. The fund has a flexible "go anywhere" style allows the managers to seek out what they believe to be the best values in the fixed income markets. They are not shy about holding high yield or foreign paper. 30% of the fund is currently committed to non-U.S. dollar bonds. Canada, Mexico, and Australia carry the largest foreign country allocation, providing a nice hedge to the weak dollar. Current distribution rate: 5.6%.

Tax-free California municipal bonds had a wild ride last quarter, as concerns about the health of monoline insurers became front page news. Many municipal issues carry insurance to cover bond holders in the event of default. Large insurers such as Ambac and MBIA ran into difficulty as they also insure mortgage-backed securities. Less than ½ of 1% of all municipals have ever defaulted, so the bond market has discounted the insurance issue and prices have moved back up. We added to our position in the **American Century CA High-Yield Municipal Fund** (BCHYX), with a current distribution rate of 4.9%.

<u>Reverse Mortgages</u> – With the mortgage industry in layoff mode, many mortgage brokers have begun marketing to cash strapped consumers suggesting that a reverse mortgage may be the answer. The idea here is to turn your home equity into a stream on monthly income that will pay you the rest of your life or until the house is sold. These programs can make sense for a home owner who is age 70+ and is strapped for cash, but has a large amount of equity in their home. We have always advised against this type of strategy in the past due to the very high fees buried in the product. Over the years these programs have become more competitive, but still are no bargain. If you or a friend are considering a reverse mortgage, please let us know and we will be happy to refer you to a mortgage specialist in this area.

I would be remiss for not mentioning Warren Isenberg, Vice President of WFA, and my trusted associate for all his hard work and 10 years of service. Lisa Leahy, our administrative specialist and notary, just celebrated her 16th anniversary with the firm. We are fortunate to have them on our team.
Scott Walker, CFP
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Client holdings will vary based on individual objectives, different inception dates and manager discretion.
Securities discussed in this bulletin may not be appropriate for all client accounts.