Review, Outlook and Opinion April, 2009

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Turning the Corner – Spring time brings new growth, and the warmer weather has also shed sunshine on our accounts lately. For those of us that hold equities, it was a rough start to the year, but we ended the quarter with a nice bounce higher in March. Central banks have been cutting short-term interest rates in an effort to reflate the global economy, and many fiscal stimulus measures have also been put forth by the new Obama administration. All of these moves have created a sense of hope that the worst may have passed. We acknowledge that risks are still present, and we may well see another down draft in stock prices, but given a two to three year time horizon, many equities appear reasonably valued and we are cautiously optimistic. With cash yields collapsing to less than 1%, investment-grade corporate and municipal bonds are looking good. We are concentrating the bond exposure in the short – intermediate area of the yield curve with the bulk of our holdings in the one to five year maturity range.

Fed Policy – Fed Chairman, Ben Bernanke made a guest appearance on 60 minutes recently to help reassure America that he has a firm grip on the wheel. Mr. Bernanke stated that he believes the economic downturn will bottom later this year and we will be on the road to recovery next year. Among a variety of measures intended to stimulate the economy, the Fed recently announced a plan to purchase over $1 trillion of Treasury and mortgage-backed securities in the open market. This massive injection of liquidity into the system is intended to ease the credit market log jam and stimulate aggregate demand. As the recession progresses, consumers and businesses have reduced spending and increased savings. The accommodative governmental measures are intended to fill the gap and prevent a deflationary price spiral from developing. Over the next year or two, as the economy begins to revive, the authorities will need to throttle back, or we risk inflation becoming a problem. That should be easy for the Fed, but if past performance is any indication, Congress may have a problem cutting spending. If that's the case, prepare for higher income taxes down the road as the Obama administration attempts to increase revenue to offset higher spending.

Rule of 72 – How long might it take to for account values to recover the lost ground from previous high water marks? The answer depends upon your personal allocation and exposure to stocks, along with the timing of the stock market recovery. The rule of 72 tells us how long it will take for your money to double in value. Take your assumed rate of return and divide that number into 72. For example, if you assume a 7.2% annual return, your money will double in ten years. 3.6% = 20 years. If you can meet your financial objectives with the lower returns from fixed-income securities or you cannot stomach the short-term volatility of having a portion of your portfolio in stocks, than it's OK to play it close to the vest and avoid equities. No one rings a bell at the market bottom and those inflection points are only clear in hindsight. Big gains typically occur when investors are totally demoralized and have fled to cash for a safe haven. Over the past 12 bear markets dating back to 1929, the average one-year return following the bear market trough was 46%. Holding some cash for emergency reserves is smart, and holding bonds for regular income and diversification makes sense, but long-term wealth is built through equity ownership.

Exchange Traded Funds (ETF's) – Over long periods of time, small company value stocks have historically produced the highest returns. So we recently added to our position in the **iShares Russell 2000 Value Index** (IWN) on price weakness. For large company U.S. stock exposure, we own the **Vanguard Dividend Appreciation ETF** (VIG), and the **SPDR S&P Dividend** (SDY). Both of them own blue chip titans that have a history of increasing their dividends. We're betting that dividend cuts have peaked and that our upside potential is greater than the downside risk at this point. Top holdings in VIG include Wal-Mart, IBM, Johnson & Johnson, Proctor & Gamble, and Chevron. The SDY has a larger exposure to financials, and has been showing the best recent relative strength lately.

Sector Plays – We continue to hold the **SPDR Gold Shares** (GLD), a trust that holds gold bullion in the form of London good delivery bars (400 oz.) which are held by HSBC Bank USA, in its London vault or in the vaults of sub-custodians. This holding serves as insurance against uncertainty in the geo-political and economic arenas. Given the large and growing cost of the federal bailout and accompanying budget deficits, GLD acts as the ultimate hedge against the erosion in value of paper currency and future inflation.

As a direct international play on the Pacific Rim we added a small position in a single country fund, the **iShares MSCI South Korea** (EWY). Tensions with their neighbors to the North crushed the fund last year, but it has been leading the pack during the recent rally. This is an indirect play on China, and is one area of the world that will continue to grow.

Oil prices have caught their balance, and even though demand is currently depressed, we do not believe the move is over for commodity and natural resource shares. The **Energy Select Sector SPDR** (XLE) provides exposure to the majors and the equipment and service companies. We were stopped out of **United States Natural Gas** (UNG) last quarter, and will avoid this form of partnership ETF in the future. We have purchased some individual company stocks to supplement our holdings in this area with **XTO Energy** (XTO) and **Plum Creek Timber** (PCL).

We have reestablished a position in the **SPDR S&P Biotech** (XBI). Former top holding Genentech was acquired last month by Roche Holdings in Switzerland. Look for more acquisitions by big pharma. Powerful demographics are working in our favor, but we are also encountering some head winds from Washington as the administration wrestles with health care access and cost containment issues. Stay tuned.

Common Stocks – The trend has certainly turned higher since the low of March 9th. In past bear markets, stocks began moving higher several months prior to any improvement in the economic statistics, as the market begins to anticipate improving fundamentals. As a famous Nebraskan recently stated: "If you wait for the robins, spring will be over." With many stocks beaten down to multi-year lows, we have redeployed cash into some new names and also purchased additional shares of some existing holdings at favorable prices. Blue chip dividend payers like **Chevron Corp.** (CVX), **Hewlett Packard** (HPQ), **Johnson & Johnson** (JNJ), and **Proctor & Gamble** (PG) are Dow 30 components we own and continue to like. Utility stock **FPL Group Inc.** (FPL) is on the safer end of the equity spectrum, and recently increased their dividend, 3.6% current yield. The company is a leader in green energy initiatives with solar power and wind generated electricity representing two growth areas for the firm through an unregulated subsidiary.

Technology is leading this rally with the NASDAQ setting the pace. Stick with **Google** (GOOG) for internet content and advertising, and wireless leader **Qualcomm** (QCOM). Infrastructure spending from federal stimulus money will provide new business for construction machinery firms like **Astec Industries** (ASTE), they manufacture equipment used in road building and have no debt. **Allergan Inc.** (AGN) had good news with unsolicited buy out interest from Glaxo Smith Kline. **Wells Fargo & Company** (WFC) is digesting the Wachovia acquisition and will emerge as one of the strongest players in the financial services industry.

Last quarter we implemented risk control measures to limit downside risk, and the decline in stock prices triggered stop loss limit orders that had been set in advance at approximately 10% below the 12/31/08 price. Stocks were sold as prices declined past our 10% loss threshold in order to preserve capital. While it's been a relatively short time since we sold, the strategy looks good with several issues like UNG, GE, FSYS, and INZ which all declined further after we sold. However, several other stocks that declined and triggered the automatic sells like BHP, NEM, CSCO, INTC, MSFT, DIS, and CPKI have turned higher. We do not know whether the recent gains in these issues will hold, but we do know that our loss was capped and we avoided a potentially larger loss. We will continue to evaluate this policy moving forward and plan to relax the stop rule where we are comfortable being long-term owners of strong businesses where we trust the management.

Trust Preferred Securities – In the past we have allocated up to 10% of a portfolio to these corporate debt securities. After getting crushed last quarter, it appears the worst of the storm has passed for the financial industry trust preferred shares. As rumors of bank nationalization swirled around, **Bank America Capital 7%** (BAC+W) and **MBNA Capital 8.2%** (KRB+E) dropped in price. **Bank One Capital 7.2%** (ONE+W) which is now part of JP Morgan Chase, and **Wells Fargo Capital 7%** (WSF) held up the best. Prices declined as investors feared that dividends might be suspended, as banks continue to struggle. These are long-term corporate obligations which we purchased at a discount to par value, believing that the higher yields compensated us adequately for the longer maturity. We misjudged the extent to which the problems in the financial sector would impact the bonds and preferreds. These bank trust preferreds are technically debt securities, and are higher in the capital structure than the TARP preferreds that the government received for their cash injections. The authorities are currently stress testing the big banks, so we will soon have a clearer picture of the health of their balance sheets. At this point, dividends continue to be paid on all our preferred holdings.

Stock Funds – We have been scaling back our actively managed funds and buying more exchange-traded funds and individual common stocks. However, we still like **Vanguard Primecap Core** and **Capital Opportunities** with their overweight in technology. The best risk return profile of any international fund belongs to our long-time favorite the **Matthews Asian Growth & Income Fund**. This stalwart has outperformed the S&P 500 each year for the past ten years.

Bonds / Fixed-Income Investments – Tax-exempt municipal bonds, including State of CA general obligation (GO's) issues saw their prices move higher last quarter, reversing the downtrend from 2008. During the 1930's, not one state defaulted on their municipal bonds. GO's are backed by the full taxing power of issuing jurisdiction. The State of CA just increased sales and income tax rates to deal with the fiscal imbalances in Sacramento. While we own some CA GO's, our favorite tax-exempt bonds are related to essential services, like those issued to finance the expansion or renovation of water storage facilities or sanitation systems.

Investment grade corporate bonds have also turned higher in price and represent good value. We have recently purchased short-term bonds from **Caterpillar Financial**, **Nationsbank (BofA)**, and **Simon Properties**, with yields to maturity from 6 – 9%. U.S. Treasury bills, notes, and bonds have elevated prices with very low yields, so we have avoided this area. Junk bond defaults look to increase, so we are steering clear, but emerging market bonds have stabilized, with **Global High Income** (GHI) up 3% for the quarter. This closed-end fund is trading at a 20% discount to net asset value and has a 10% current yield.

We have increased our holdings in the **Vanguard Short-Term Investment Grade Bond Fund** for a lower risk 4.6% current yield. The **Metropolitan West Total Return Bond Fund** is a core fund that is defensively positioned with a 3.3 year average duration. We have known the Los Angeles based portfolio managers for years and share Morningstar's enthusiasm for this top-rated analyst pick. The fund has a broad mandate and has loaded up on Fannie Mae and Freddie Mac mortgage-backed securities which are now backed by the U.S. government. The fund paid an above average distribution in March, however we expect the annual yield to be in the 6% range.

Mortgage Advice - We encourage all clients to pay extra on each monthly payment in order to shorten the life of the mortgage and save on interest costs. Many clients own their homes free and clear, and many refinanced in 2003 when interest rates were at a low point. Mortgage rates are currently near the lows touched in 2003. While rates may dip further, consider refinancing now if you have an adjustable rate loan or a fixed rate of 5.75% or higher. Evaluate the stability of your income, and think seriously about moving to a 15-year fixed rate loan. Your interest rate will be approximately ¼% lower than a 30 year fixed-rate, and you will save thousands in interest costs over the life of the loan. If you can handle higher payments, the payoff is huge. Check with your existing lender and local bank for quotes. We also have relationships with mortgage brokers and would be happy to refer you to a qualified professional in this area. Thanks for your continued trust and confidence. We are working hard to continue to earn it.