Investment Review & Outlook April, 2010

By: Scott Walker, CFP

The bull market in stocks and bonds remains intact. We had a brief dip from mid-January into early February, but ended the quarter at near 52-week highs. Many economic indicators have turned positive and stock prices generally reflect that optimism. The U.S. unemployment rate remains elevated at 9.7%, but this is a lagging indicator that typically rebounds later in the cycle. American business has adopted a leaner operating structure in order to compete, so we continue to like large company dividend paying blue chip stocks. Large caps have lagged in the recovery, but have improved balance sheet strength by paying down debt. These stocks derive a portion of their revenue from other countries, so we also have a built in hedge against a potentially weak U.S. dollar. We own stocks from different industries producing cash flow growth that can justify dividend increases. However, there are no guarantees with equities, which is why we also own bonds for a higher degree of safety.

Our philosophy is to maintain a balanced posture by owning both stocks and bonds. This provides growth potential with peace of mind. Your mix is a function of your age, risk tolerance level and our professional judgment. For the first quarter, our account values moved higher to post an average three-month net return of 3.12%, after all fees and Schwab costs. In aggregate, our privately managed client accounts are 42% invested in equities, so this was an above average quarter. We continue to advocate a balanced posture for the majority of clients with an appropriate allocation to equities for capital appreciation and dividends, with bonds for income and less risk. Client portfolios are customized based on individual preferences, so your performance will vary based upon your asset allocation targets and specific holdings.

No one knows what uncertainty may lurk around the corner, so we are always cognizant of the downside risk for each of our holdings. We never want to be forced to sell good companies simply because the broad market decides to go down, so we attempt to structure portfolios with holdings that will act as stabilizers when the weather turns nasty. These would include high quality corporate and municipal bonds, and gold (**SPDR Gold Trust** - GLD, **Barrick Gold Corp.** - ABX). High quality bonds and gold are negatively correlated to stocks, meaning they tend to go up in price when stocks go down, which helps to limit the overall volatility of your account. Cash and money market funds are safe, and it's smart to have excess reserves when bargains present themselves. But, there is an opportunity cost with nil short-term interest rates. Owning short-intermediate term bonds fills the gap nicely between cash and stocks.

Bonds – Corporate, municipal, and mortgage-related bonds, have all moved to near 52-week high prices. Emerging market bond funds led the pack, with **Global High Income** (GHI) +15.9%. We have reduced our exposure by trimming off and selling shares in GHI, and the **Metropolitan West Total Return Bond Fund** to lock in gains. Cash yields continue to disappoint, as the Fed keeps the short-term Fed Funds rate anchored at 0 – 0.25%. Mr. Bernanke has stated that the Fed intends to keep interest rates low "for an extended period", so no relief anytime soon for CD investors at the bank. U.S. Treasury prices have continued to struggle (3/31/10 10-year Treasury yield 3.83%) Is there a sense that federal government spending and the growing U.S. national debt may be out of control? Greek debt woes recently sparked a safe haven bid for Treasuries, so the day of reckoning has been postponed. There is also the matter of the Asian central banks (particularly China) continuing to buy U.S. debt, as the value of the Chinese yuan versus the dollar heats up.

We have increased our holdings in non-dollar denominated bonds with the addition of the **Templeton Global Bond Fund**. This fund has large positions in South Korea and Sweden, with a current yield of 4.4%.

Splitting your exposure between individual bonds and bond funds gives you the best of both worlds. Individual bonds have the certainty of return of principal with a set maturity date, while bond funds provide more diversified exposure with a monthly dividend.

Build America Bonds (BABs) – This new breed of taxable municipal bonds were first issued in April, 2009. The BAB program is very popular with both issuers and investors. The federal government pays a 35% direct subsidy to the issuing entity to defray interest costs. This subsidy has been a boon for state and local governments and in many cases has enabled them to come to market at a far lower cost versus traditional tax exempt issuance. For investors, BABs compare favorably to other similarly rated taxable corporate issues. BAB interest is federally taxable, but exempt from State income tax.

The use of BAB proceeds by a municipal issuer is restricted to capital expenditures and may not be used for working capital or to facilitate the refunding of an existing issue. In general, the credit quality associated with BABs is very high. Approximately 78% of the $64 billion of BABs issued in 2009 were rated AA or better. We participated in the fourth quarter with the **Moulton Niguel Water District** issue, and will evaluate the terms of other new offerings coming to market. The BAB program is currently set to expire at the end of 2010, so most analysts expect BAB issuance to double in 2010 as issuers rush to take advantage of the federal subsidy.

Preferred Securities - We have reduced our exposure to traditional fixed-rate preferreds, but have purchased a floating rate preferred stock issued by **Goldman Sachs Group, Inc.** (GS+A). The Goldman preferred is tied to LIBOR, a short-term rate which is currently very low. The security guarantees a minimum 3.75% dividend yield, on the $25/share par value. At a recent price of $22.75, the shares trade a 9% discount and yield 4.12%. Traditional preferred stocks carry no maturity date, but when interest rates rise over the next few years, Goldman will likely call the security at par, or $25.00/share in cash to us.

Equities – We are diversified with holdings in many industries. Energy, utilities, and gold were the laggards in the first quarter, so we have increased our allocation to these areas. Our retail holdings have caught fire as retail sales numbers have perked up with consumers starting to spend again. Banks continue to work through a mountain of mortgage-related issues, but the low short-term interest rates have given them some breathing room to restore margins and return to profitability. Top-performers for the quarter included **Berkshire Hathaway** (BRKA, BRKB) +23.2%, **Wells Fargo** (WFC) +15.5%, **Buckle, Inc.** (BKE) +26.4%, and **Pricesmart** (PSMT) +15%. First quarter performance was hurt by **Google** (GOOG) -8.5%, **NRG Energy** (NRG) -11.5%, **FPL Group, Inc.** (FPL) -7.5%, and **Ultra Petroleum** (UPL) -6.4%. We continue to like the fundamentals and future prospects for all of them.

A new position was established in our local utility company **Sempra Energy** (SRE). Sempra is the holding company for San Diego Gas & Electric and Southern CA Gas. It's a low-risk dividend paying blue chip that we acquired 14% below its recent high at a 3.2% current yield. Sempra is also involved in green energy with solar and wind production, along with LNG (liquefied natural gas) facilities.

Many technology stocks continue to pace the market. We purchased the **Rydex S&P Equal Weighted Technology** (RYT) to get low cost exposure to a broad cross section of the industry. This exchange-traded fund's strategy has outperformed traditional capitalization weighed technology indexes.

Actively Managed Sector Funds – After lagging last year, health care stocks rallied following the passage of health care reform legislation. This landmark bill expands coverage and demand for services, but also imposes significant additional taxes on health insurers which will cause premiums to increase. We are relying on the acumen of Kris Jenner, M.D. the portfolio manager of the **T. Rowe Price Health Sciences Fund** to sort through the labyrinth of provisions to pick the winners under the new regime. Following an eight year hold, we took our profits and recently sold the Vanguard Health Care Fund and upgraded to the better performing and smaller T. Rowe Price fund.

Estate Planning – An integrated financial plan needs to address what happens to your assets when you are no longer able to manage them for yourself. The use of a living trust and naming a co-trustee can eliminate some major transition hassles. In addition, probate is avoided which eliminates court interference, delays, and minimizes costs for your estate. A Durable Power of Attorney for health care also lets you make important choices prior to a life threatening event. If you need to have your estate plan reviewed or updated, please let us know and we will be happy to refer you to an attorney who specializes in this area.

Your asset allocation is the key driver of volatility and returns. We are ever mindful of the downside risk, but take comfort in the overall high quality of our holdings. If you have questions regarding your portfolio, or have other funds you may wish to consolidate at Schwab, please call or email. Thanks for your continued trust and confidence. We are working hard to continue to earn it.

April 12, 2010