Wealth Management & Investments April, 2011
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Building and preserving your wealth is our primary objective. We espouse a balanced portfolio with an age appropriate weighting in fixed-income securities to manage risk, while still maintaining an equity component to capture the higher potential returns from stocks. Our guiding principles are to:

1) Make money
2) Hold stocks for capital appreciation and bonds for safety & steady income
3) Keep costs low
4) Avoid large losses
5) Minimize income tax

We are off to a good start this year with a positive first quarter for all client accounts. The net average total return for the quarter across all client accounts was 2.80%. In aggregate, our privately managed client accounts are 45% invested in equities, so this was an above average quarter. Client portfolios are customized based on individual preferences, so your performance will vary based upon your inception date and specific holdings.

The Japanese earthquake, tsunami and nuclear crises topped the headlines for the quarter. The devastation and loss of life give us pause, but they are a resilient culture that will rebuild and recover. There have been supply chain disruptions from industries in the affected area which will temporarily impact the earnings of many companies.

Domestically, the economy is slowly regaining momentum and growing corporate earnings have been a positive catalyst for higher stock prices. Business spending is a bright spot due to generous tax deductions for equipment and capital investments. Bond prices were flat to higher in the first quarter as the Fed continues its accommodative monetary policy via a U.S. Treasury bond buying program (QE 2) through June 30th. The consensus opinion is for interest rates to rise as a result of government deficit spending and more U.S. debt issuance. Over the next several years this will likely happen as the market begins to discount the inflationary implications of our profligate fiscal policies. However, we believe it's likely that the 10-year Treasury rate will remain range bound between 3 and 4% through the end of the year (3/31 – 3.46%), with the Fed being reluctant to tighten policy and raise short-term rates until 2012.

Many strapped homeowners have stopped making payments on their mortgage as they try to negotiate a loan modification in lieu of a short sale or foreclosure. The aftermath and consequences of the popping of the residential real estate bubble are still unfolding which is one reason the Fed is in no hurry to raise interest rates. An ancillary issue is the revenue shortfall that many cities and counties will be facing due to the decline in property values.
Payment of municipal bonds takes high priority for governmental agencies, but a potential revenue shortfall bears watching as budgets come under increased scrutiny.

Equities – U.S. stocks posted their best first quarter since 1998, with the S&P 500 up 5.6%. Conditions are favorable for continued gains in stocks, but after such a strong quarter, a pull back in prices would not come as a surprise. Our best gains last quarter came from the energy and technology sectors. The pain at the pump and $112/barrel oil prices feel a little better when you see the prices of **Chevron** and **Exxon Mobil** trading near all-time record high prices. Houston based **Ultra Petroleum** with their natural gas focus has lagged, but still represents good value. **International Business Machines** and **Qualcomm** were our tech standouts. Most of our Qualcomm position was sold last quarter as our target price of $54/share was achieved.

Industrial stocks rallied with the recovery now firmly entrenched. **Dupont De Nemours & Co.** posted an 11% advance for the quarter. Dupont was the top performing Dow stock for 2010 and still represents decent value trading at a P/E of 15 based on $3.70 of projected earnings for 2011, with 13% projected earnings growth and a 3% dividend yield.

The natural disaster in Japan hurt **Toyota Motor Corp.** which has declined 18% from its 52-week high. Toyota has also had their share of recall problems, but is still #1 in the world in automotive sales with a commitment to lower carbon emissions and greater fuel economy. We believe that the market has over discounted the future business prospects of this global automotive titan. Toyota operates 51 manufacturing facilities outside of Japan in 26 different countries.

Pricesmart, Inc. operates 28 membership warehouse clubs in Central America and the Caribbean. We reestablished a position in this company recently when the price came down. Last quarter revenue grew 23%, while earnings grew 30%. Low debt on the balance sheet, and management still owns 34% of the stock, so their interests are clearly aligned with us.

Areas of weakness last quarter included large cap pharma as governmental pricing pressures and increasing competition have become stronger head winds. We are reducing our exposure to this area. **Microsoft** and **Google** both struggled, but we remain committed to both. Google recently named co-founder Larry Page CEO, replacing Eric Schmidt, who remains Chairman.

Bonds – There are two main risks to keep in mind when investing in bonds or bond funds. The first is credit risk, meaning the risk of default which implies an impairment of interest and principal repayment. I am happy to report that Warren and I sleep well at night knowing the credit risk is very low with the bonds we own. The other big risk with bonds is interest-rate risk. This is a function of the maturity date or duration of your bond holding, and is most pronounced with long-term maturities. If longer term Treasury yields in the market move up after you've purchased a bond, the price on your bond will be marked down to compensate for the higher current market yields available. This is not a problem if you hold the bond to maturity, but can result in a lower temporary value on your statement.

Remember that U.S. Treasury yields are the safe benchmark against which all other bond yields are measured. The difference between the Treasury yields and the yields on other bonds is referred to as “the spread”. During the credit crises of 2008 and early 2009, spreads exploded as prices collapsed on most bonds, except U.S. Treasuries which rallied in the flight to safety. The recovery over the past two years has seen spreads narrow significantly to a point where little value remains in corporate investment grade and high yield debt. With this in mind we have reduced our high yield bond exposure and locked in a gain on our junk bond ETF holding, the SPDR Barclays High Yield Bond (JNK). We plan to reinvest the sale proceeds into more shares of the **Doubleline Total Return Bond Fund**. Historically, mortgage-backed securities have been one of the least volatile areas in the fixed-income market. The credit crises and housing bust have created opportunities for bargain shoppers in this area. The Doubleline team led by portfolio manager Jeffrey Gundlach, has razor sharp expertise in these securities. The fund continues to generate a superb yield of 8.5% with low volatility.

Treasury bonds have declined 15% in price since their recent high last August and represent a good short-term contrarian turn around opportunity. Last quarter we extended our duration by adding the **Ishares Barclays 20+ Year Treasury Bond** (TLT). This ETF is a convenient low cost way to gain access to long-term Treasuries. 4.4% net current yield, with a 0.15% expense ratio. Treasuries typically rally when stocks sell off, so TLT gives us a safe-haven hedge against stock market risk. Our target price is $95, but if we’re wrong and interest rates suddenly rocket higher, we sell at $88 and cut the loss.

Municipal finances continue to grab headlines which has cast a black cloud over the municipal bond market. Prices bottomed in mid-January and have been stable to higher since. We are avoiding bonds issued by the State of CA due to the budgetary imbalance, but there are other local general obligation and revenue bonds that are economically sound where we are comfortable holding to maturity. Banks and insurance companies have continued to be big buyers of municipal bonds which has offset the selling pressure from muni fund redemptions. We have taken advantage of the market dislocation to selectively add to our municipal bond holdings as pricing became more favorable. We are favoring the 6-9 year maturity range to limit interest-rate risk and still earn a respectable yield. We also reestablished a position in the **American Century CA High Yield Municipal** fund in January. This is the most conservative fund in its peer group and holds a diversified mix which produces a current distribution rate of 5%, free from federal and state income tax.

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.

Income Tax – Congress and President Obama were gracious enough to extend the Bush tax cuts for two years through 2012. This means that long-term capital gains and qualified stock dividends continue to be taxed at a maximum federal rate of 15%. For those still working, be sure to maximize your annual contribution to a pre-tax retirement savings plan. This is a guaranteed way to reduce your income tax and help assure a more comfortable financial future. If you are approaching retirement or have funds sitting in an old 401k, a tax-free direct rollover to a managed IRA provides increased investment flexibility and greater control.

<u>Estate Planning</u> – 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. Having a Durable Power of Attorney for property and health care is also imperative.

Remember that an individual can gift up to $13,000 annually with no tax implications for the donor or recipient. There are also numerous advanced estate planning techniques for larger estates. If you would like 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.

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