Client Bulletin
July 2006

Economic & Market Update – The Fed continued to raise short-term interest rates by pushing the short-term Fed funds target rate to 5.25%. There have now been 17 consecutive 0.25% increases since interest rates bottomed three years ago. Mr. Bernanke and his fellow FOMC members aim to control inflationary pressures and dampen real estate and stock market speculation, while still allowing the economy to grow at a moderate pace. If it becomes apparent over the summer that housing weakness is spreading into overall consumer spending, then the odds will favor a pause at the August 8th meeting.

We are in a seasonally weak time of year and believe that equities are undergoing a normal correction, not the start of a bear market. Investor sentiment has turned negative, and although the U.S. consumer is under pressure to cut spending, market fundamentals remain solid. Valuations are reasonable and corporate sector finances are in excellent shape.

Portfolio Commentary – Following an exceptionally strong first quarter, equity markets topped out in early May, and have pulled back recently on inflation and interest rate fears. We ended the second quarter slightly in the red, but year-to-date we are up. With the exception of our energy and natural resource holdings, most U.S. equity positions were lower. Growth stocks, particularly in the technology area were the hardest hit, as stock option compensation practices have come under scrutiny. International markets also sold off. Three of our largest positions, the **First Eagle Overseas Fund, Dodge & Cox International Stock Fund**, and **Matthews Asia Growth & Income** all bucked the trend and posted positive results for the quarter. Fixed-income securities were mixed. The **PIMCO Floating Rate Income Fund** (PFL) was our best performer. The **Global High Income Dollar Fund** (GHI) was hurt by the sell-off in emerging markets. We have held and are accumulating more shares. Our individual bonds and preferred stocks were flat to slightly lower in price.

For most clients we employ a balanced strategy with healthy doses of fixed-income securities to cushion the downside risk when stocks sell off. Capturing dividend streams in the 6-9% range with closed-end bond funds and preferred stocks provides steady cash flow that we can count on. Cash is not trash anymore as the **Schwab Advisor Cash Reserves** money market yield is approaching 5%. We have been buying **U.S. Treasury bills** and short-term AAA-rated U.S. Government Agency securities issued by the **Federal Home Loan Bank**. These direct investments give us a little higher yield than the money market and are State of CA income tax-exempt.

Market Timing or Asset Allocation? – If the outlook is murky for the coming months, why not sell stocks and move to cash? This type of market timing maneuver would provide temporary relief from any short-term stock market decline. The problem is that it's easy to sell, but no one rings a bell at the bottom, and attempting to time the reentry is extremely challenging as the stock market can shoot higher in a very short period of time as witnessed in the last week of the quarter. Once you have sold, you tend to view any market rallies as temporary, and the months go by and eventually the stock holdings you sold are at higher prices, so you wait for another correction to reenter. When the sell off finally comes, you think stocks will keep going lower, so you hold off buying back in, and the waiting game continues.

We prefer to focus on selection as opposed to timing and control risk through our asset allocation. With up to ten different asset classes, we build a well-balanced portfolio to weather short-term market volatility. This does not mean we never sell, as we did trim back and take profits on some of our biggest winners last quarter in many client accounts. This rebalancing technique allows us to get back to our original targets for equity and fixed-income exposure. We will also make changes when the fundamentals of an investment change, or a more attractive alternative becomes available. Individual client circumstances and objectives also play an important role in our portfolio design. Feel free to contact us if you would like to discuss your individual allocation.

Staying Informed – Warren Isenberg and I traveled to Chicago in late June to attend the annual Morningstar Investment Conference. Over 1,500 advisors, investors, and members of the media attended this year's event. We were treated to panel discussions and presentations by some of the best investment minds in the business.

Paul McCulley, from PIMCO in Newport Beach told us that central banks around the world are in a tightening mode. Real estate has been a key driver of the American economy over the past few years as the mortgage industry came up with creative ways to allow people to tap into home equity and qualify new buyers. The volume of real estate transactions has crashed and inventories of unsold homes are double what they were a year ago. He sees Fed tightening slowing the economy to a soft landing, which will set the stage for Fed easing later in 2007. His firm is over weighting interest rate risk in the U.S. and extending maturities.

Bill Nygren, manager of the **Oakmark Select** and **Oakmark Fund** was a keynote speaker and stated that high quality large company growth stocks in the U.S. are extremely attractive. Names like **Citigroup**, **Home Depot**, **Wal Mart**, and **Harley Davidson** have been new additions to his fund. Six years ago, these blue chips sold at absurd multiples of earnings, but with the subsequent price declines and earnings continuing to grow, they now trade near parity with the S&P 500. So he's getting above average businesses at average prices. He invests with a five-year time horizon and stressed that money with a shorter time horizon should not be invested in stocks.

Diana Strandberg from **Dodge & Cox International** reminded us that more than ½ the world's stock market capitalization sits outside the U.S. Many of these companies are under researched which leads to more opportunities to exploit inefficiencies. Her firm has 20 research analysts that cover foreign markets. Japan carries the largest country weight at 26% of the fund. Consumers in emerging markets will be a big driver of future growth. **Nestle** and **Nokia** are two holdings domiciled in developed markets that are tapping into this growth.

David Winters of the **Wintergreen Fund** stated that they are big "non-U.S. dollar investors" and are finding more opportunities for investment outside the U.S. **HSBC**, the global financial powerhouse is a new acquisition for the fund. He has also purchased **Consolidated-Tomoka Land**, an old timber company he was able to buy at a discount to intrinsic value. The company has no debt and the city of Daytona, Florida is growing into their land.

We appreciate your continued trust and confidence.
Scott Walker
July 10, 2006