Review, Outlook and Opinion July, 2007

By: Scott Walker, CFP

Many stock markets around the world hit all-time record highs last quarter buoyed by a slew of private equity deals in the U.S. and strong economic growth overseas. After topping out in May, most of our accounts pulled back in June as long-term interest rates moved higher, which depressed the value of many of our fixed income holdings. Inflation expectations are the key driver of long term rates, and with oil prices hitting $72/barrel, and employment, income, and economic growth numbers trending higher, the Fed will remain vigilant on the inflation front. We believe abundant global savings will keep a lid on long-term interest rates (10 yr. Treasury yield is currently 5.18%). We do not expect Mr. Bernanke and Fed to adjust their target short-term rate (currently @ 5.25%) for the rest of the year.

Across all client accounts, we ended the 2nd quarter higher, with an average net gain of 3.25%, after all fees and costs for the three months. Year-to-date we're up 4.93% and over the past year 14.97%. The majority of our accounts are structured with a balanced posture, so we catch the majority of any upside moves in the stock market, with lower volatility when things get tough. It's not surprising to see prices pull back following the nice gains posted through May. We could easily have several months of choppy price action with a modest correction over the summer, allowing earnings expectations to ease, setting the stage for another up leg. Higher corporate earnings are the fuel for higher stock prices, so we will closely scrutinize upcoming earnings reports and future guidance. Equity valuations remain reasonable, and we continue to see companies return cash to shareholders with dividend increases &/or stock buybacks. Corporate balance sheets have never been in better shape. The global economy is strong with capital flows favoring international stocks as they continue to outpace their U.S. counterparts.

What could go wrong? The residential housing market bears close scrutiny. The extent of the rogue lending practices in the sub-prime mortgage industry, and the fallout from the lax lending standards is becoming more apparent. Bear Stearns recently announced a multi-billion dollar bail out of a hedge fund that specialized in mortgage related securities tied to sub-prime loans. An Irvine, CA broker-dealer, Brookstreet Securities was in the news last week after they had to mark down the value of collateralized mortgage obligations (CMO's) held in client accounts. These securities rely on the payment stream from sub-prime loans to meet their interest obligations. The problem is that Brookstreet brokers had purchased these risky derivatives on margin for customer accounts. With the recent write downs in value of these securities, the firm now has a negative net capital and may be forced to close and liquidate. Over the last year, 60 sub-prime mortgage lenders have gone out of business in the U.S., with the largest failure being New Century Financial in Irvine. Could there have been a tie in between New Century and Brookstreet?

Investor cash that might have been targeting a real estate investment a year ago is now gravitating towards stocks and tax-free bonds, which provides a solid underpinning of demand for equities and municipal bonds.

U.S. Equity Funds – Last quarter we completed our exit from the **Diamond Hill Long Short Fund** with a small profit. For our moderate to aggressive accounts we purchased the **Fidelity Leveraged Company Stock Fund** (FLVIX). This fund has a mid-cap bias which is where the majority of private equity and leveraged buy outs have occurred. Manager Tom Soviero's strategy revolves around buying what he considers attractively valued stocks that issue high-yield debt or otherwise have leveraged capital structures. He looks for companies that have a catalyst for improvement, such as a management change, a new product, or a pricing change. With a team of Fidelity analysts in his corner, Soviero can leverage the firm's high yield and equity research. The fund has large holdings in the energy and information technology sectors and will be more volatile than most, but the results have more than justified the higher risk.

International Equity Funds – These funds continue to dominate the top performing positions for our portfolios. Given the inter-related dynamics of our global economy, we plan on holding a meaningful percentage in foreign equities for the foreseeable future. For many longer-term clients that have participated in the large gains over the past four years, we have trimmed back to rebalance and take some profits. However, we continue to like and own large positions in all of the international and global funds previously discussed in past bulletins.

Our federal budget deficit and trade deficit expose structural weakness in the U.S. and have put downward pressure of the dollar. Holding securities denominated in other currencies acts as a hedge and counterbalance to our U.S. holdings. When the dollar declines, securities denominated in foreign currencies get a lift. While we do not attempt to time currency swings or count on exchange rates for extra returns, the weak dollar has contributed to the strong showing of many of our international stock funds. We caution clients to not expect the outsized returns of recent years to repeat over the next few years, as many foreign markets will need some time to digest the strong recent gains.

Common Stocks – Last quarter we initiated positions in two business development companies (BDC's) for many clients. Private equity investment in securities of companies that are not listed on a public exchange is typically off limits to most investors. The standard private equity fund carries a $5 million minimum and a 10-year commitment to an investment that pays no annual distributions. A BDC is a listed investment company and provides the entree to this vibrant segment of the economy by investing shareholder money in loans and equity stakes of small privately held enterprises. These target companies generally have annual revenues of $50 - $500 million, but lack access to bank financing. Congress passed legislation creating BDCs in 1980. They pay no corporate income tax as long as they distribute at least 90% of their ordinary taxable income to shareholders. This results in annual dividend yields in the 7-9% range for us as investors. We took positions in **American Capital Strategies** (ACAS) and **Apollo Investment Co.** (AINV). Both firms have a history of increasing dividends and positive share price performance. Following the end of the quarter, American Capital was named as a new entrant to the S&P 500 stock index. We expect demand to increase for the shares of both firms in the years ahead as the quest for income generating investments intensifies with the leading edge of the baby boomers approaching retirement age.

On July 2, **Charles Schwab & Co., Inc.** (SCHW), the parent of Schwab Institutional announced a special $1/share dividend payment and a tender offer to buy back 7% of the company's outstanding shares. Following the recent sale of U.S. Trust Co. to Bank of America, Schwab was flush with cash and will be rewarding shareholders accordingly. Schwab stock soared throughout the late 90's as it was caught up in the technology stock mania. Like many others, it dropped sharply during the bear market, bottoming in early 2003. Founder and Chairman Charles Schwab, had turned over the reins to David Pottruck as CEO. Mr. Pottruck made some ill advised acquisitions and was subsequently asked to resign by the board. Mr. Schwab, who owns 18% of the company, has since returned to the leadership role and restored confidence among employees, customers, and shareholders.

Starbucks Corp. (SBUX) has not worked out according to plan. We expanded our holdings in this company earlier this year after the price had pulled back. We did not anticipate the short-term weakness in the shares due to higher commodity (milk & coffee beans) prices and overseas expansion outlays. We continue to like the company growth prospects as they are less than ½ way toward their goal of 40,000 stores worldwide. SBUX now has 200 stores open in China, with many more on the drawing board. The company has joint ventures with Pepsi-Cola and Dreyer's to develop bottled coffee drinks and ice creams, and a partnership with Kraft Foods to distribute coffee in grocery stores. Howard Schultz, the founder and chairman is still at the helm and is overseeing the new music and breakfast offerings. We believe the firm's best days are yet to come.

Your holdings may not include all stocks discussed due to different client inception dates and manager discretion.

Preferred Stocks – We went against the grain last quarter and began buying preferred shares in **Hovnanian Enterprises**, a large nation-wide home builder. Recent losses have crushed their common stock, and their 7.625% perpetual maturity traditional preferred stock (HOVNP) also traded down below $25/share par value. The company has a manageable debt load and offers a quality product. Officers and directors own 26% of the company, so they are clearly aligned with our interests. This holding does qualify for the 15% maximum federal income tax rate on dividends.

Bonds – Safe and liquid cash in money market mutual funds pays almost 5%, and we also hold the **Schwab Yield Plus Select** ultra-short term bond fund (SWYSX, 5.5% yield) as a cash equivalent. For safety and certainty we hold individual bonds directly issued by the Federal Home Loan Bank. These short-term notes due in 6 – 36 months are AAA-rated by S&P, and have coupons in the 5.25 – 5.50% range, which are CA state income exempt. Given the mediocre yields on investment grade intermediate and longer term bonds in the 5-6% range, we attempt to spice things up with preferred stocks, leveraged closed-end bond funds, and reverse convertible notes. Through dividends or interest we typically get paid at least 7-9%, and 10% or more for many structured products (reverse convertibles).

Our firm has purchased 15 different reverse convertible note issues over the past year for various client accounts. Only one, **ABN AMRO Bank**, tied to Starbuck's (SBUX) common stock has exceeded the downside protection and pierced the barrier price. Unless the stock rallies back to exceed the initial fixing price by the maturity date on 7/31, we will receive shares of common stock in SBUX instead of cash. For every $1,000 invested, we will get 29.5 shares, with fractional shares paid in cash. Only one other note is close to the barrier price, which is **JPMorgan Chase**, tied to Whole Foods. These two issues were our worst performers last quarter, but the growth and expansion opportunities have never been better and we believe that management can get things back on track, so we plan to hold.

We placed a six-month bet in late June on a new issue note linked to **Indymac Bank**, (IMB). Their stock is 38% off its 52-week high having been drug down through guilt by association with the sub-prime mess. But, IMB has minimal sub-prime exposure as they specialize in Alt-A loans, a class that falls between sub-prime and prime. These loans have not seen a big spike in defaults or foreclosures. IMB is the nation's seventh-largest savings & loan with a strong balance sheet. Although earnings have dipped, they are doing a brisk business in reverse mortgages for retirees. This reverse convertible note carries an above average 30% downside protection from the recent $30.62 fixing price, along with a 15.50% interest rate.

Closed-End Bond Funds – The second quarter was not kind to our holdings in this asset class. Higher interest rates tend to spook these funds, so the June spike in yields sent many of these issues tumbling. With the exception of the **Pimco Floating Rate Income Fund** (PFL), all of our closed-end income funds posted negative total returns for the three month period. With one exception, dividends have held firm, continuing to provide us with generous yields and cash flow. Given the recent price weakness, some of these funds have begun to look attractive again for new purchases. The **Nuveen Mult-Strategy Income Fund**, (JPC), **Nuveen Equity Premium Income Fund** (JPZ), and **Nuveen Global Government Enhanced Income Fund** (JGG) all sport yields in the 8-9% range based on their recent quarterly dividends.

Clients in the 25% or higher Federal income tax bracket can benefit from tax-free municipal bonds. We sold the **Nuveen CA Municipal Value Fund** (NCA) last quarter believing that a dividend cut was eminent. For selected clients we replaced it with the **Nuveen CA Dividend Advantage 3**, another tax-free closed-end fund with a higher yield of 5.1% vs. 4.6%. We also continue to like the PIMCO line-up of closed-end bond funds. They are prized in the secondary market and have consistently traded at a premium to net asset value. Their CA muni funds yield 5.5% and 5.6%, tax-free. Remember that most closed-end funds do utilize approximately 1/3 leverage via short-term borrowings to produce their above average yields, so if the Fed resumes raising rates or the bond market sells off, we could see renewed price weakness. We view that as a low probability event, and are happy to capture the extra income from these unique vehicles.

In Conclusion – Your returns will vary depending upon your entry date, risk tolerance, personal objectives, and asset allocation. Warren Isenberg and myself work together to preserve and grow your capital. We eat our own cooking as demonstrated by the fact that we personally own many of the same securities found in your accounts. If you have had or expect any material change in your family finances or status, please let us know. Questions or comments regarding any material in this bulletin are welcomed. Thank you for your continued trust and confidence.