Investment Review & Outlook July, 2010

By: Scott Walker, CFP

Has the Storm Passed? – Nasty winds blew through our accounts following the April 23 high water mark. Stocks declined, while bonds gained in value. Stocks, as measured by the S&P 500 were -11.4% for the 2nd quarter, and -6.7% year-to-date. Our more balanced total return approach produced an average client return of -2.7% for the quarter, and 0.03% higher year-to-date, net of all fees and Schwab costs. Those with a more aggressive profile than 40% equities dipped more, but will participate more fully in the subsequent rebound. Client portfolios are customized based on individual preferences; therefore, your holdings and performance will vary based upon your start date and target asset allocation.

The road ahead looks promising from this point, but there pot holes to avoid and clouds on the horizon. We'll keep the umbrellas handy for you by owning high quality bonds to help cushion the inevitable stock market swings. Interest rates continue to scrape the bottom of the barrel in the U.S., with record-low CD and mortgage rates. However, governmental authorities in several foreign countries have started to raise interest rates, like South Korea to 2.25%. Australia, Norway, Canada, Brazil, New Zealand, and Malaysia have also hiked rates this year. The U.S. target short-term rate, the Fed Funds is currently set at 0.00 – 0.25%. The 10-year Treasury bond ended the quarter yielding 2.94%, falling below 3% for the first time in 14 months on persistent worries over contagion from the euro zone fiscal mess and concerns that the U.S. is heading for double dip recession. The fears may have been overblown, as stocks have stabilized and turned higher in early July. We continue to maintain a balanced posture by owning both equities and fixed-income securities. Your allocation target is a function of your age, risk tolerance, and our judgment.

Client Privacy / Identity Theft – Each morning we review all client account activity from the previous day before posting to our system. Recently we noticed an unusual $40,000 client cash withdrawal. After phoning the client, it was quickly determined that an intruder had gained access to the account and forged a signature on a Schwab wire transfer form. The $40,000 had been wired to China Merchants Bank in China. An additional $80,000 of stocks was also sold the morning of the discovery. Schwab was able to lock down the account to thwart the thief, while reversing the stock sales and crediting the sold shares back to the account. Schwab has also re-deposited the $40,000 cash back into the client account, and continues to pursue recovery with the bank in China. Please rest assured that your privacy and the confidentiality of your information is very important to us. We ask that you take every precaution with your sensitive personal and financial information.

Equities – We own stock in market leading companies with a competitive advantage which drives revenue and earnings growth. This gives management the flexibility to pay down debt, increase the dividend, or buy back stock. Second Quarter Company results kick in this week with **Google** (GOOG) and **JP Morgan Chase & Co.** (JPM) announcing on Thursday. Both companies stocks have been pummeled this year, but are poised to rebound higher. GOOG just had their license to do business in China renewed after a recent spat with the government. GOOG has no debt, $80/share in cash, and a dominant global search franchise. Financial stocks sold off as the regulatory reform details were being hammered out by Congress. Stick with JPM and **Well Fargo & Company** (WFC) to prosper in the years ahead regardless of what obstacles the regulators create.

Our equity strategy has always been to invest in market leading companies with a strong competitive advantage. We also seek to layer in holdings that will act as shock absorbers and cushion the blow when stocks inevitably correct. For insurance against the debasement of paper currencies hold up to 5% in the **SPDR Gold Trust** (GLD). Is gold only ½ ways through its current up cycle? The metal hasn't yet hit its all-time high in real terms, suggesting the market isn't overheated. On the open market, the all-time inflation-adjusted price came in 1980 when gold fetched $873 an ounce, or $2,015 today including thirty years of inflation.

Gold mining stocks also tend to move with gold prices, so we own shares in **Barrick Gold Corp.**, (ABX) for extra spice. These two alternative investments did particularly well last quarter which helped to offset other decliners.

Energy Sector – The oil & gas industry has been under the microscope since the BP deep water well accident in the Gulf of Mexico. The company's new cap appears to be working, but the long-term impact and future liability are far from certain. We reduced our broad industry exposure by selling the SPDR Energy ETF (XLE), and instead have added more **Ultra Petroleum Corp.** (UPL), and **Chevron Corp.** (CVX). UPL is more levered to domestic natural gas, while CVX is a global titan. Ultra has the industry's lowest cost structure and owns valuable producing wells in Wyoming and Pennsylvania. Chevron does it all with exploration, production, refining, transportation, and over 22,000 retail locations. A new CEO took the reins last year and the company announced a dividend increase in April to $0.72, producing a 4% yield.

Dividend-Paying Stocks – Several more of our holdings announced dividend increases last week including **ExxonMobil** (XOM), **International Business Machines** (IBM), **Johnson & Johnson** (JNJ), and **Proctor & Gamble** (PG). FPL Group in Florida has changed their name to **NextEra Energy Inc.** (NEE), and boosted their dividend in February.

Stock Mutual Funds – Last quarter we took our profit and sold the **Wintergreen Fund**. The fund became an average performer and ultimately was judged to not be worth the almost 2% in expenses we were paying David Winters. We're sticking with **Matthews Asian Growth & Income** (MACSX) for a smooth ride with China exposure as our #1 international pick.

Morningstar Conference Insights – Both Warren Isenberg and myself travelled to Chicago in June to hear various fund portfolio managers discuss their outlook and favorite holdings. Dr. Kris Jenner, portfolio manager of the **T. Rowe Price Health Sciences Fund**, gave an excellent overview of the recently enacted Obama health care program. This sweeping legislation will provide health care coverage to 32 million previously uninsured Americans. Many details in the 2,500 page bill need to be clarified and the law is to be phased in over several years, but Dr. Jenner stated "the math doesn't work" when discussing how we're all going to pay for it. He is negative on managed care and medical insurance companies, while concentrating on highly innovative service firms and demonstrated low-cost providers. He reconfirmed our belief in **Teva Pharmaceutical Industries Ltd.** (TEVA), the largest generic drug company in the world, based in Israel. Generic penetration in the U.S. is 70%, versus approximately 20% in other countries around the world.

Michael Hasenstaab, portfolio manager with the **Templeton Global Bond Fund**, is focused on bonds from countries that have low debt to GDP ratios. Surprisingly, many of the emerging markets now have lower ratios of debt to GDP than older developed markets. He has a zero weighting in U.S Treasuries, UK gilts, and Japanese bonds. The fund owns sovereign (government) credits from Australia, Norway, Brazil, and Russia among others, and provides a nice compliment and hedge to our dollar-based U.S. bond holdings. China and India have also raised interest rates to cool speculation and overheated growth. If a country has a positive balance of payments and trade surplus, rising interest rates can benefit a currency and the associated government bonds from the country. **Global High Income** (GHI) is a higher octane closed-end emerging markets bond fund which we also hold for more risk tolerant accounts.

Bonds – The majority of outstanding bonds moved higher in price last quarter. U.S. Treasuries posted the best gains with the dollar showing strength. With many bond fund prices near 52-week highs and dividends being reduced, we sold a couple of Pimco funds to lock in gains. Bill Gross, the famed bond manager from Pimco, has publically stated that dividend paying stocks offer better value than many bonds today. However, there are still bargains to be found in bonds where the rating agencies have not yet caught up to changing company fundamentals. **GMAC** is one example where the company is now profitable and has been renamed **Ally Bank**. The U.S. government has invested $25 billion and now owns 65% of the company, so we believe they will be around to pay off our 6.75% bonds maturing in 2014. **Ford Motor Credit** is a similar story, but without the government aid.

Splitting our exposure between individual bonds and bond funds gives us the best of both worlds. Individual bonds have a set maturity date and coupon % annual interest rate, while bond funds provide more diversified exposure and more frequent cash flow with a monthly dividend. Since yields have declined, interest rate risk has increased with longer-term issues, so we have been reluctant to extend maturities. Deflationary forces are evident today with excess global capacity, but the enormous amount of government spending and build up of debt are sowing the seeds for inflation down the road.

Bond Funds – Our favorite shorter maturity fund is the **Vanguard Short-Term Investment Grade** (VFSTX), 3.6% yield. Last quarter we established a new position in the **Doubleline Total Return Bond Fund**. This is a new fund managed by Jeffrey Gundlach, the highly regarded ex-TCW bond manger who departed late last year. A core group of ex-TCW people formed Doubleline in Los Angeles, so we have an experienced manager with a new fund. Gundlach's specialty is mortgage-backed securities, and he's still finding distressed merchandise on the secondary market with high single digit yields.

Tax-exempt municipal bonds continue to shine with the prospect of higher tax rates coming in 2011. We own the high quality **Vanguard CA Intermediate-Term Tax-Exempt** (VCAIX) 3.7% yield, the **SPDR Barclays Capital CA Muni Bond** (CXA) 4.2% yield, and the **American Century CA High Yield** (BCHYX) 4.9% yield (Yield refers to current annualized distribution rate based on the most recent monthly dividend).

<u>Preferred Securities</u> – We have continued to reduce our exposure to traditional fixed-rate preferreds which carry long-term maturity dates. Although the **Goldman Sachs Group, Inc.** (GS+A) floating rate preferred hurt us last quarter, the price weakness has allowed us to add more shares. This Goldman issue is different than most in that it is a floating rate security. The company guarantees a minimum 3.75% dividend yield, on the $25/share par value. But at a recent price of $17.95, the current yield is 5.2%, and we have $7/share of upside when there is any whiff of higher interest rates.

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 monies you would like to discuss, please call or email. Thanks for your continued trust and confidence.

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