Client Bulletin
October 2004

Economic & Market Update – The economy is steady but there are still bumps in the road. Oil prices are now over $52/barrel and gas at the pump is approaching $2.50 a gallon. The Presidential election is less than 30 days away and a clear winner has yet to emerge. Local real estate activity has gone flat with many more “For Sale” signs staying put in neighborhood yards. The overall stock market has been weak, but certain areas have seen good gains. Energy, basic materials, and utilities have been up. Technology and pharmaceutical stocks have been weak. Foreign stock funds have outperformed U.S. funds for the quarter and year-to-date.

Following the big rebound in 2003, most clients have continued to make money in 2004 with our balanced approach blending equity and fixed-income securities. Our accounts have had a nice surge up since bottoming in mid-August. Historically, September has been the worst performing month for the U.S. stock market, with October right behind. So, theoretically this is the time to be buying to take advantage of the lower prices for our growth money. For those who are risk averse, we minimize stock exposure and add value with fixed-income securities. What’s ahead? Just as everyone was worried about the war in Iraq, record high oil prices, the hurricanes in Florida, and interest rates moving up, the stock market surprised us and has rallied. We remain cautiously optimistic knowing that equities are volatile in the short-term, but out perform bonds and cash over the long haul.

Bond prices surged back during the third quarter. Remember earlier in the year when interest rates shot up across the board and bond prices were hammered? Everyone was bracing for higher interest rates. Well, even though the Fed boosted short-term rates by another ¼% last quarter, longer-term rates actually declined. The 10-year Treasury rate hit 4.87% in mid-June, then declined to under 4% in September. Since the end of the quarter, interest rates have turned back higher, perhaps sensing inflationary pressures starting to build. The expanding federal government budget deficit and trade deficit entail that the U.S. issue more debt. More supply, leads to lower prices and potentially higher interest rates.

Presidential Election – It’s neck and neck but the reelection of President Bush is widely perceived on Wall Street as more bullish for the markets than the election of Senator Kerry. The Senator vows to increase taxes for the wealthy and may boost the tax on dividends and capital gains, thus undoing much of the stimulus that’s bolstered the economic and stock market recovery. Senator Kerry has vowed to pull back U.S. forces in Iraq, which would reduce defense outlays. Although some may be tempted to exit stocks if pro-business President Bush is defeated, keep in mind that in both 1976 and 1992, Democrats beat Republican incumbent presidents and the market subsequently rallied. Good companies will find a way to make money regardless of who’s in office.

International Stock Funds – American’s appetite for foreign goods seems to be insatiable. From consumer electronics to automobiles, the U.S. continues to import more than we export. As long as the dollar holds up and foreigners continue to buy U.S. government bonds, everyone is happy. It's no surprise that Asian central banks have become the largest holders of U.S. Treasury bonds.

Longer term this imbalance could create problems, which is a fundamental reason why we own foreign stocks. They provide a valuable hedge against our U.S. holdings and the dollar. Our foreign exposure is primarily via the following mutual funds: **First Eagle Overseas**, **Dodge & Cox International Stock**, **American Funds – New World**, and **Capital World Growth & Income**, and **Matthews Asia Growth & Income**. Only the Matthews fund is closed to new investors. All of these funds have posted positive returns for the quarter and year-to-date. Although First Eagle and the American Funds family traditionally carry front-end loads, we buy the shares for you without the load.

<u>Sector Funds</u> – These funds give us a concentrated play on a particular industry and are the most volatile type of mutual fund. We'll devote 5% of a portfolio to a sector fund to ride a trend. Our largest holding continues to be the **Vanguard Health Care Fund**. The fund holds approximately 100 stocks with top holdings **Pfizer**, **Eli Lilly & Co.**, and **Amgen**. Exposure to **Merck** had been reduced, so damage was limited from the Vioxx arthritis drug problem.

A new buy was recently made into the **Ishares Goldman Sachs Semiconductor Index Fund (IGW)**. Ishares are a series or brand of exchange-traded funds (ETF's) put together by Barclays Global Investors that trade on the American Stock Exchange (AMEX). ETF's are a tax efficient low cost way to target a sector. This digital revolution play focuses on semiconductors or "chips". These tiny devices are made from silicon and house the brains for computers, cell phones, digital cameras and many other devices. Top holdings are capital equipment maker **Applied Materials**, **Motorola**, **Texas Instruments**, and **Intel**.

This area has been toxic since early in the year, down over 30%. We noticed the share price turn higher on above average volume a couple of weeks ago; a false rally, or the beginnings of a nice move up? Many of the companies have recently guided lower so we're betting the bad news is priced in and corporate spending on IT upgrades will hold steady in the 4th quarter and increase in 2005.

Last quarter we prematurely took profits on our **Oil Service Holders Trust (OIH)** to preserve a 20% gain. All energy-related stocks have continued higher and may go higher still. Global petroleum demand is expanding as Southeast Asia and particularly China continue to expand trade with the rest of the world. The supply of many commodities has been tight, so prices have gone up. We have been evaluating the **T. Rowe Price New Era Fund** as a buy candidate to increase our exposure to natural resources. The fund owns 90 stocks and top holdings are **Newmont Mining**, **Exxon Mobil**, and **BP PLC ADR**. **BHP Billiton PLC**, an Australian natural resource company with ties to China is a recent addition. The fund carries a low expense ratio of 0.72%.

The **Energy Select Sector SPDR (XLE)** is a higher octane version of the New Era fund. SPDR's are another brand of ETF. This one forges all 27 energy holdings from the benchmark S&P 500 and charges low expenses of 0.28%. Many familiar names in this one including **ChevronTexaco** at 15% of assets. Both of these funds have been on fire, so we're looking for a pull back to get in. We'll pay Schwab a commission of each of these, but worth it.

<u>Fixed-Income</u> – Given the run-up we've experienced with our fixed-income picks, we are treading lightly with new money as beat up bargains are few and far between. We're using a couple of ultra short-term bond funds to pick up some additional yield versus the 1% money market rates. The **Schwab Yield Plus Select Fund –** yield 2.6%, and the **Metropolitan West Ultra-Short Bond Fund –** yield 3.2% pay monthly dividends with minimal share price movement. Last quarter we bought back into the **Metropolitan West High Yield Bond Fund –** yield 8.2%, as the economy appears to have enough strength to support high yield prices. Remember that high yield bonds are issued by less seasoned companies. They carry lower credit ratings and pay more interest than investment grade corporate bonds issued by older more established firms. High yield bond prices are not as interest rate sensitive as other bonds, so even if market interest rates move higher, we expect high yield prices to remain firm.

Our worst performing bond fund last quarter was the **ProFunds Rising Rate Opportunity Fund**. This fund is designed to prosper when long-term interest rates move higher. This is just the opposite of a regular bond fund, which would experience a share price decline in a rising rate environment. Given the funds 8% decline last quarter, we believe it has excellent turnaround prospects moving forward.

Owning individual bonds gives us the certainty of a maturity date when our principal will be returned. It can also result in our principal being returned early if a bond is called, or redeemed prior to maturity by the issuer. Keeping with our defensive posture, we are buying "step-ups", where the coupon rate increases at set intervals over the life of the bond. For example we recently purchased a AAA-rated U.S. government agency bond issued by the **Federal Home Loan Mortgage Corp.** (Freddie Mac) maturing in 2014. The initial coupon rate is 4% through 2/07, then steps to 5% until 2/09, 6% - 2/11, and 7% to maturity. This type of structure will hold its value better in an increasing rate environment versus a standard straight coupon bond.

State of California general obligation (GO) municipal bond prices got a boost recently when credit-rating firm Standard & Poors lifted the state's bond grade three notches to A from BBB. S&P cited a better economy and the use of long-term borrowing to stave off a potential budget crisis.

We had another partial call from **Price Legacy** on the 8.75% preferred issue held by many clients. The cash proceeds and a pro-rated dividend were deposited into our accounts on 10/1. Expect the remaining shares to be called in the future. The majority of preferred stocks are callable by the issuing company five years after issue at par. Since we bought this one under par at a discount, we make a small capital gain on top of the 8.75% dividend we've enjoyed over the years.

<u>Income Tax</u> – Now is the time to review your income tax situation for 2004 and take action to minimize your liability. Consider cleaning out your closet and donating any old clothes for a charitable deduction. For clients who are still working, contributing the maximum to your employer sponsored retirement plan is essential. Self-employed clients need to check out the new deductible Health Savings Accounts. We will be reviewing all regular brokerage (non-IRA) accounts for clients before the end of the year to assess the gain/loss situation. Capital losses are first used to offset gains, and then up to $3,000 annually may be deducted against ordinary income. Excess losses may be carried forward indefinitely. Congress recently passed legislation extending some popular tax breaks that were scheduled to expire at the end of the year. We would be happy to review your overall position with your tax advisor to insure you are getting the maximum possible savings.

Schwab Update – You may have read about the recent change at the top of **Charles Schwab & Co., Inc. (SCH)**. The board recently asked David Pottrock, President and CEO to resign. He had engineered some acquisitions that took the company away from their roots as an advocate for the individual self-directed investor. Founder and Chairman, Chuck Schwab has agreed to return to the CEO position to get the firm back on track. Schwab Institutional, the division of the company that we deal with has seen continued growth as consumers continue to seek the services of independent fee-based advisors. The problem lies with Schwab's retail branch system. They have announced some branch closures and layoffs to cut costs. Overall the company is profitable and we continue to get good service and are happy with the lower commission rates they have implemented this year. We are not happy with the performance of the common stock and are evaluating the merits of maintaining our position versus other alternatives.

Feel free to contact us with any questions or comments.

Scott Walker

October 8, 2004