Client Bulletin
October 2005

Economic Update – Hurricanes Katrina and Rita have wreaked havoc and created short-term hardships for many in the Southern states. Economic growth will likely slow through the end of the year buffeted by higher energy costs, as damage to production and refining facilities in the gulf crimps supplies. Driven by Asian growth, worldwide energy demand continues to grow. Economics 101 taught us that steady demand and tighter supplies lead to higher prices. The prices of oil, natural gas, and energy-related stocks hit all-time record highs near the end of September. There has been some profit taking in recent days, but given the world economy's thirst for fossil fuels, we are very comfortable holding our natural resource positions.

The rebuilding effort and massive fiscal stimulus from Washington will boost economic growth next year. Can our Federal budget handle the additional strain as President Bush vows to spend "whatever it takes" to make up for a lack of past infrastructure upgrades and FEMA's slow response to the Katrina? Prior to the hurricanes, Congress approved a $286 billion highway bill that reeked of pork. Will we reduce our spending in Iraq to compensate for what needs to be done at home? Time will tell, but recent progress on the Federal budget deficit is likely to evaporate moving forward.

Fed Watch / Interest Rates – The Federal Reserve surprised the markets and recently hiked short-term interest rates for the 11th straight time to quash inflationary pressures and dampen speculative activity in the real estate market. Many had thought the Fed would pause in their monetary tightening to give the economy a reprieve in light of the short-term dislocation caused by Katrina. Alan Greenspan, chairman of the Federal Reserve reported that American households borrowed almost $600 billion against the value of their homes last year. He also stated that the purchase of second homes, perhaps for speculative purposes, was playing a bigger role in the housing market. We would be very leery of committing new capital to the real estate market today.

Longer-term interest rates also moved higher toward the end of the quarter with the benchmark10-year Treasury bond yield closing at 4.33%. With one year Treasury Bills now paying over 4%, we have a very flat yield curve with little reward for long-term bond investors. Long-term rates have remained stubbornly low as global capital continues to gravitate into U.S. Treasury bonds. One reason is that local interest rates in many foreign countries are even lower that the U.S. 10-year government bond yields in Japan are 1.42%, Switzerland 1.87%, and Germany 3.10%. All of these rates are lower than a year ago.

Fixed-Income – Holding a meaningful percentage, 40-80% of a portfolio, in securities that pay interest or dividends reduces volatility and helps clients sleep well. We add value by blending a unique mix of asset classes in this area that include both open-end and closed-end bond funds, individual bonds, and preferred stocks. We also categorize our energy master limited partnership, **Kinder Morgan Energy Partners** (KMP) 6%

yield, and our timber REIT, **Plum Creek Timber** (PCL) 4.2% yield, as fixed-income holdings. This varied mix of securities provides ballast in stormy markets. Prices have run up on many of our favorites, but we continue to add to the **Metropolitan West Strategic Income Fund** (MWSTX) with a 4.7% yield, and the **Coastal Finance** (CGP+T) and **Truststreet Properties** (TSY+A) preferreds which both yield over 8%. Believing we're heading into a tougher interest rate climate with mortgage lending and real estate activity slowing, we sold **Thornburg Mortgage**, a real estate investment trust (REIT) to preserve capital. The dividends were sweet, but they can be cut when business slows.

For California municipal bond exposure, it's tough to beat the closed-end **Nuveen CA Select Tax-Free Portfolio** (NXC) with a monthly dividend and a 4.6% tax-free yield. This fund was launched in 1992 and holds older higher yielding bonds. It trades on the NYSE at a slight discount to its net asset value. A newer closed-end fund we have recently started to buy is the **PIMCO Floating Rate Income Fund** (PFL). It also trades at a discount and with short-term interest rates moving higher this year, PFL has increased its dividend twice producing a current yield of 7.7%.

Stock Mutual Funds – The broad U.S. stock market has produced mediocre returns this year with the S&P 500 index up only 2.8% through 9/30. Fortunately, for the majority of our clients we owned significant positions in international stock funds along with energy and natural resource positions that have worked well. The **First Eagle Overseas Fund**, **Dodge & Cox International Stock Fund**, **Matthews Asian Growth & Income Fund**, and for more aggressive accounts, the **American Funds – New World Fund** have continued to out perform domestic funds again this year. With the twin budget and trade deficits, the recent dollar rally could reverse, which would benefit our foreign stock positions. International funds also provide valuable currency diversification and an avenue to participate in overseas opportunities in the dynamic global economy.

Our flagship **Oakmark Select Fund** posted a gain of only 0.27% for the quarter, as Washington Mutual, its largest holding, has struggled along with other financial stocks. We still believe in manager Bill Nygren and his value philosophy, but when a better opportunity becomes available, we look to trim profits from big winners. Look for a partial sale of Oakmark Select or the **Oakmark Fund** during the fourth quarter to free up money to purchase the **Wintergreen Fund**. This new no-load global value mutual fund is currently in SEC registration and will be managed by David Winters. Mr. Winters has an esteemed record having learned the business from Michael Price with the Mutual Series Fund family. In the mid 1990's we made money with their Mutual Discovery Fund. We sold the fund in 1996 when Price sold the fund complex to Franklin Templeton. Winters stayed on board and became one of the star managers at the firm. Mr. Winters recently left Franklin Templeton to start Wintergreen Advisers, LLC and launch the Wintergreen Fund. Once the fund is launched, we plan on establishing initial positions for all but our most conservative clients.

Berkshire Hathaway (BRKA) and the baby Berks (BRKB) which are equal to 1/30th of each "A" share, have been a disappointing performer over the last two years. There is an ongoing SEC investigation into questionable business dealings between the former CEO of General Re, Berkshire's reinsurance arm, and AIG. In addition, the insurer will surely be hit with hurricane related claims. We have continued to accumulate more shares as the price has dropped believing that Berkshire's diverse business interests and earnings power will overcome the short-term negatives. Higher short-term interest rates have enabled interest income to rise more than 20% so far in 2005 on the $40 billion in cash the company holds. Many of the noninsurance operations are performing well including apparel and building products.

Sector Funds – Energy and utilities have been the two hottest domestic sectors for the quarter and year-to-date. We will devote up to 20% of a portfolio to sector funds for clients comfortable with more volatility. The **Energy Select Sector SPDR** (XLE), **T. Rowe Price New Era Fund** (PRNEX), and **Eaton Vance Utilities Fund** (EVTMX) continue to be our favorites.

Excluding large pharmaceuticals, many health care stocks have also been moving higher, and we've participated with the **Vanguard Health Care Fund** (VGHCX). Unfortunately, this fund is now closed so we are unable to buy it for new accounts. However, we've discovered a nice alternative with the new **Vanguard Health Care VIPERs** (VHT), an exchange-traded fund, or ETF. What are ETF's? They are baskets of securities, often meant to mimic a market index, that are traded on national stock exchanges. They combine the benefits of open-end index mutual funds—diversification with low operating costs and tax-efficiency—with the trading flexibility of individual stocks. Top holdings in VHT include **Pfizer**, a turnaround candidate, **Johnson & Johnson**, **Amgen**, **United Health Group** that recently announced an acquisition of **PacifiCare**, and **Medtronic**. VHT was introduced in January, 2004 at $50/share, and closed on 9/30 at $53.46. We will pay Schwab a trading commission of $12.95 for clients receiving econfirms, and $19.95 for others. The fund carries a rock bottom expense ratio of 0.25%. For taxable accounts, we will be looking at harvesting the tax loss from Pfizer and buying VHT as a replacement.

Tax-Planning – For taxable client accounts, each year in the fourth quarter we review realized gains and losses and consider possible trades to make prior to 12/31 to minimize any taxable capital gains. Capital gains may be offset by capital losses, and then up to $3,000 of excess capital loss may be used each year to offset ordinary income (wages, interest, and dividends). We typically do not buy stock mutual funds for taxable client accounts in the 4th quarter to avoid the year-end capital gains payout. For clients still working, the 401(k) maximum contribution limit for 2005 is $14,000, with an additional $4,000 available for those age 50 and older. Self-employed individuals with no employees may be able to obtain a larger deduction with the new individual 401(k) plan versus a SEP/IRA. If you have any questions or would like to review your portfolio tax status, please contact us.

We appreciate your business and look forward to helping you achieve your long-term financial goals.

Scott Walker October 10, 2005