

## Client Bulletin October 2006

**The Scorecard** – While we prefer to focus on longer-term performance, we are happy to report strong results across the board for the most recent quarter. There will always be areas or holdings that struggle from time to time, but it is the overall portfolio results that count. Please review your Portfolio Performance Summary to view your net returns over various time periods. Your individual return will depend on your asset allocation, risk tolerance, and need for safety and income. For taxable brokerage accounts, remember that a portion of your gain will be non-taxable, from unrealized gains in price appreciation, or tax-free income from municipal securities.

**Economic & Market Update** – The Fed paused last quarter after 17 consecutive 0.25% rate hikes. Throw in a decline in oil prices from a July high of \$77/barrel to the low \$60 range, and inflation concerns have begun to dissipate. The residential real estate market has turned down with the inventory of homes for sale continuing to grow as sellers reluctantly reduce asking prices. We have a client in Laguna Hills that recently reduced their asking price \$100,000 to \$775K for a very nice single family home, and still no reasonable offers. Given the tremendous gains over the past 10 years, we were due for a pullback.

We are seeing a global economic slowdown and return of excess savings. The surge in savings has been created by a sharp rise in Asia's current account surplus at a time when the U.S. consumer may also try to spend less. China saves close to ½ of its GDP every year and has now become the biggest creditor of the United States. These factors may explain why our long-term interest rates have turned lower. There is a consensus developing that the Fed will reverse course and cut rates in 2007 to avoid tipping the economy into a recession. So just as everyone was bracing for higher interest rates, the bond market went the other way and had a big rally pushing long-term interest rates back down.

September and October have historically been the two weakest months for stocks. So much for history repeating itself this year, as the Dow reached a new all-time high today of 11,866. The recent drop in oil prices and bond yields are positives for equities. Both rising oil prices and interest rates act as a growth tax that chips away at profits and siphons off spending power. By the same token, a fall in energy cost and long-term rates should stabilize and stimulate business activities and profits. Upcoming earnings announcements, and more importantly future guidance will be keys to price action for the rest of the year and into 2007.

**Equities** – Most of our energy and commodity related holdings saw price declines last quarter, while financial service and technology shares, the laggards from the second quarter, surged higher. Larger company value and growth stocks in the U.S., along with selected international stock funds continue to offer good value. **Oakmark Select**

(OAKLX), **Vanguard Primecap Core** (VPCCX), and **Transamerica Premier Equity** (TEQUX) are large company stalwarts. **First Eagle Overseas** (SGOVX), **Matthews Asia Growth and Income** (MACSX), and **Dodge & Cox International Stock** (DODFX) continue to be three of our excellent long-term core foreign stock holdings. We have taken the opportunity to selectively trim profits and rebalance to reduce risk for clients that have experienced large equity gains.

We maintain broad exposure to different industries and always seek to upgrade our holdings when a new or more attractive idea or holding comes to our attention. We took a new position last quarter in the **Diamond Hill Long/Short Fund** (DHLSX). This fund is different than any fund we own, as it has the ability to make money when stocks go up (long positions) and when stocks go down (short positions). Short securities currently represent 32% of net assets. Management follows an independent disciplined intrinsic value approach. They will buy small, mid and large cap companies at prices below their appraisal of intrinsic value. They will sell stocks short if the market price is at a premium to intrinsic value. The largest long positions in the portfolio are concentrated in the energy sector and include **Phelps Dodge**, **ConocoPhillips**, and tech giant **Microsoft**. During the 2<sup>nd</sup> quarter, the fund established new short positions in video rental provider **Netflix** and **P.F. Chang's China Bistro**. With our consolidated buying power, we were able to buy the lowest cost institutional share class.

**Fixed-Income Securities** – Given the higher bond prices, we are finding few bargains and have allowed cash to grow. Cash equivalents, including your money market account keep funds safe and liquid with a competitive yield in the 4.7% - 4.9% range. We earn a 5.5% current yield with low risk short-maturity funds like **Metropolitan West Strategic Income** (MWSTX) and **Schwab Yield Plus Select** (SWYSX). We extend maturities and add value to pick up 7-8% yields with preferred stocks and closed-end income funds, many of which have experienced sharp price gains.

We are in the process of adding a new closed-end fund, the **Nuveen Equity Premium Income Fund** (JPZ) to our accounts. The fund pays a monthly dividend and has a current distribution rate of 8.9%, utilizing an integrated equity index option strategy. The fund will write covered options to generate income on its blue chip stock portfolio. Top holdings include **Exxon Mobil**, **General Electric**, **Bank of America**, and **Proctor & Gamble**. The market price of the fund jumped higher before we could accumulate a full position and now trades at a premium to net asset value; however, we will look to add to our position on price weakness.

**Risk Tolerance** – Have your feelings about risk changed since we initiated our relationship? For many, we have made periodic adjustments, but if you are unsure about how your account is positioned relative to your risk profile, we can help. Just click on [lisa@walkerfinancial.com](mailto:lisa@walkerfinancial.com) and send her an email. Type risk quiz in the subject line and she will email you nine questions so we can get a current read on your risk profile.

**Pension Protection Act of 2006** – On August 17, 2006, President Bush signed this legislation into law. Some highlights include a provision that allow IRA owners who are

ago 70 ½ or older to make a tax-free donation directly to a charity of up to \$100,000 from their IRA instead of taking a taxable distribution. The donation can be counted toward satisfying their required minimum distribution. Other new provisions were included that allow rollovers by non-spouse beneficiaries from company retirement plans, and participant direct rollovers to Roth IRAs (Income limitations do apply).

### **2006 Retirement Plan Contribution and Deferral Limits:**

IRA and Roth IRA - \$4,000 / \$5,000 with catch-up (for those who reach age 50 in 2006)

SEP IRA - \$44,000

401(k), 403(b), 457 Plan Employee Salary Deferral - \$15,000 / \$20,000 with catch-up.

Simple IRA - \$10,000 / \$12,500 with catch-up

Defined Benefit Plans – Largest deductions available based on age and salary

For those with earned income, contributing to qualified plans remains the best way to minimize current income tax, while saving on a tax-deferred basis for the future.

**Wealth Management** – Is your estate plan up to date? We work with several estate planning attorneys to coordinate the document preparation process and would be happy to assist you in the process. Be aware that the annual gift tax exclusion is \$12,000 per individual donor for 2006. This amount may be gifted with no tax consequences to the donor or recipient. The 2006 estate tax exemption amount is \$2,000,000 per person, or \$4,000,000 per couple with a properly structured estate plan.

**529 College Savings Plans** – The tax-free withdrawals (federal tax only) for qualified education expenses introduced in 2001 will not expire in 2010, as previously scheduled. The new law is a reason to take a second look at 529 plans if you have a child or grandchild that has college in their future. These plans are regulated on a federal basis, but offered by individual states. You are allowed to have a plan offered by a state other than where you reside, and other than where the child attends college. Contribution limits are high, but there are more restrictions versus UTMA (Uniform Transfer to Minor) accounts which are another popular education funding tool. To learn more about 529 plans and the CA alternative, visit [www.scholarshare.com](http://www.scholarshare.com) If you are unsure which makes the most sense for your situation, give us a call.

**Schwab Edelivery** – Thank you to all the clients who have contacted schwaballiance and completed the registration process for edelivery of Schwab trade confirmations and monthly statements. Your action will help the environment and save a tree while also minimizing Schwab transaction costs. If you have not yet completed the process, please take 5 minutes with your account number(s) in hand and call 800-515-2157. Go to [www.schwaballiance.com](http://www.schwaballiance.com) and they will set you up.

We hope that you and your family are well. If you have had or expect any material change in your family income or status, please drop us a line. Thank you for your continued trust and confidence.

Scott Walker  
October 5, 2006