Investments & Wealth Management **October, 2011**

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Economic & Market Overview – Euro debt concerns with Greece on the brink of default, and slowing economic growth battered global stock markets last quarter. Germany and France are working with the monetary authorities and have set a 10/31 deadline to craft the terms of a restructuring and bailout agreement. Domestically, we have a gridlocked political system that is facing growing deficits and large future unfunded liabilities with entitlement programs that are out of control. In response to the fiscal imbalance, Standard & Poor's has cut their credit rating on U.S. Treasuries from AAA to AA+.

Housing and unemployment remain two problem areas, but manufacturing and retail indicators have steadied and are showing modest growth as opposed to the sharp declines registered during late 2008 which led to the last recession. The banks need more time to sort through the mortgage mess, so Mr. Bernanke and the Fed have stated that they will keep short-term interest rates anchored at 0 – 0.25% for the next two years. U.S. bonds staged a blistering rally last quarter, topping out on October 4, just as stock prices were bottoming. The 10-year Treasury yield declined to 1.92%, while the Dow ended the quarter at 10,913.

The upside in Treasury bond prices is limited compared to other bond sectors and dividend-paying blue chip stocks, which is why we have zero exposure to Treasuries. Many corporations have no or low debt and record amounts of cash to increase dividends, repurchase their stock, or invest in capital projects to enhance productivity. Short-term stock price movements are unpredictable, but the valuations and cash flow that stocks currently offer is compelling versus high-grade bonds, given current interest rates. We will be monitoring quarterly earnings announcements and watching the charts on daily graphs for above average volume activity which signals institutional action.

Holding cash provides peace of mind, and we have a 10-15% weighting in many accounts in order to meet withdrawal needs, and have some dry powder for bargain hunting. Staying balanced is the key with enough safe money in cash and bonds to meet your sleep well point.

Bottom Line – Our balanced asset allocation approach delivered an average net return across all client accounts of -4.6% for the quarter, and -0.70% year-to-date. Many of our more conservative accounts emphasizing bonds are up 2%+ year-to-date. While we are never happy with negative numbers, we remain focused on the longer-term fundamental strengths of our holdings knowing that market corrections are a normal occurrence. It's a temporary decline in value, not a permanent impairment of capital unless you sell after the drop and don't upgrade with a new equity position. Rather than sell everything and attempt to time the market, we mitigate the stock market risk by owning many income producing securities, which provide ballast in stormy seas along with dividends or interest.

Equities – The largest declines last quarter were in the more economically sensitive areas of financials, industrials, and energy. Consumer staples, technology, utilities, and surprisingly retail held up the best. The big losers last quarter were **JP Morgan Chase** and **Wells Fargo**, along with **DuPont**, **Deere & Co.**, and **Ultra Petroleum**. All of these companies continue to be profitable and we would be inclined to add more shares at current prices, rather than sell. However, we will look to harvest losses for taxable accounts before the end of the year. Sensing trouble in the networking sector, we cut our loss and sold **Juniper Networks** at $31/share prior to a disappointing July earnings call. The stock ended the quarter at $17.26.

Winners last quarter included **Proctor & Gamble**, **Apple, Inc.**, **International Business Machines**, **PriceSmart**, **Target**, and the **SPDR Gold Trust (GLD)**. With the exception of Apple and GLD, all pay dividends and have increased the dividend this year. **Microsoft** was sold at a small profit last quarter given their lackluster performance and slowing growth prospects. We also trimmed off and sold a portion of PriceSmart based on valuation concerns to nail down a significant gain. Shares were added to our positions in **Qualcomm**, IBM, Apple, and **Google** to ride the waves of the mobile internet and business capital spending on technology.

I would be remiss in not acknowledging the passing of Apple co-founder Steve Jobs recently. Mr. Jobs was the visionary force behind the slew of innovative products that have transformed the consumer technology experience. Apple is still firing on all cylinders under new CEO Tim Cook, and has overtaken Exxon Mobil to become the largest company in the U.S. by market capitalization. Apple reported a record 1 million pre-orders for the iPhone 4S which goes on sale this Friday.

Long time holding **Berkshire Hathaway Inc.** announced late last month that the company would look to repurchase potentially billions of dollars' worth of its own shares. This sent a strong signal that Warren Buffet believes the holding company shares are undervalued relative to their intrinsic value and other potential investment opportunities. The announcement also provided a much needed psychological boost to investor confidence. In August, 198 companies authorized new buybacks of their own shares, the highest monthly total since February, 2008. Insider buying has also seen an uptick lately as pricing became more favorable for those with a multi-year time horizon who can see past the current malaise. We like Warren Buffet's quote: "Bear markets are when you make the most money in stocks, you just don't realize it at the time"

Recent new buys include **Exelon Corp.**, a well managed utility with a 4.9% yield. For risk tolerant accounts, we reacquired shares in **Barrick Gold Corp.** Gold stocks have lagged the price increase of gold bullion, and the recent price decline presented an opportunity to pick up the world's largest miner. The SPDR Gold Trust which holds gold bullion and tracks the price of gold finally pulled back off its all-time high but still ended the quarter +8.3%. Economic, political, and monetary uncertainties have kept a strong underlying bid under gold prices. We are content to hold what we have and wait for a lower price point to add more. San Mateo, CA asset manager **Franklin Resources (BEN)** came down in price and was added for their conservative mix of funds, strong balance sheet, and attractive valuation. They have a broad global network that garners one-quarter of its assets from outside the U.S.

Bonds – We own bonds and bond funds for safety and steady income. Bond prices were mixed last quarter with higher quality corporate, municipal and mortgage-backed bonds posting gains, while our foreign bond position declined in value. Prices started to slip on a couple of bond funds where we had nice unrealized gains and the yield had also declined, so we took profits and sold the **Metropolitan West Low Duration** and **Vanguard Short-Term Investment**. Following a rough quarter, foreign bond funds represent the best opportunity for new money, so we have been adding to the **Templeton Global Bond**, with a 5% current yield.

We continue to like two actively managed funds for their specialized expertise, defensive nature, and generous payouts. The **American Century CA High Yield Municipal** provides current income that is exempt from federal and CA taxes. The fund posted a total return of 4.4% for the quarter, and pays a 5% current yield from the monthly dividend. The fund's largest holdings are in land based, hospital revenue, and electric revenue bonds.

Our core taxable bond fund is the **Doubleline Total Return Bond Fund** (DBLTX), managed by Jeffrey Gundlach and his team in Los Angeles. They continue to be successful combing the secondary market for mispriced mortgage-backed securities. Third quarter total return was 3.8%, with a current yield of 8%.

Splitting our exposure between individual bonds and bond funds provides the best of both worlds. Individual bonds have the certainty of semi-annual interest payments with a return of principal on the maturity date. Bond funds provide broader diversification and more frequent cash flow with monthly or quarterly dividends.

If you have any questions or comments regarding your portfolio, or any recent changes in your health or financial situation, please let us know. Thank you for your continued trust and confidence. We appreciate it.

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