Client Bulletin
January 2004

<u>Economic & Market Update</u> –What a difference a year makes. Following 3 down years, stock markets worldwide rallied to post impressive gains. Opening your year-end statement is sure to bring a smile. Based on the initial trading days of 2004, the party is still rolling. If only we knew it would last. What we do know is that stocks will continue to be volatile and the best way to handle that risk is through diversification and prudent security selection. Economic indicators continue to come in higher showing that production and consumption are strong. Fiscal and monetary policies are stimulative and the Fed appears content to leave the Fed funds rate at 1% for the foreseeable future. The low rates have helped create record housing prices. The low rates have also led to a consumer debt explosion. Given our federal budget and trade deficits, it's no wonder that the U.S. dollar continues to lose ground to the other major currencies around the world. As long as the dollar decline remains orderly, foreigners are unlikely to abandon their U.S. investments. U.S. exports have been growing as holders of euros and yen can buy more dollar denominated goods. This means more business for U.S. multi-national firms. China's emergence as the primary manufacturing hub for the world has had a disinflationary impact due to their low production costs. Ditto for India with their low labor costs. All things considered, we now have a synchronized global recovery that has room to run.

China is the hottest thing going as evidenced by the recent IPO of China Life. The IPO price was $19, it opened at $22 and is now over $30. The company has posted net losses for each of the last 4 quarters, so people are making some large assumptions. Seems a bit like tech mania of a few years ago when IPO's were the rage and $5 - $10 daily price moves were common. We believe in owning non-dollar denominated securities, but are limiting our international exposure to 20% of a portfolio and spreading our bets around Asia, Europe, and Latin America.

Have current stock prices already discounted all the good economic news? We've had a big recent run up and valuations certainly are not at bargain levels. The bullish argument is that low inflation, low interest rates, and increased productivity can support higher valuations in stocks. However, we believe in hedging our bets because the tide can turn quickly. Holding fixed-income securities acts as a counter balance giving us relative stability along with dividends or interest. Our bond funds, individual bonds, and preferreds cushion the ride when we hit stormy weather.

<u>Mutual Fund Scandal</u> – The late-trading and market timing abuses have fallen to the back burner as rising stock prices have taken the sting out of this wrongdoing. The guilty few skimmed the cream off the top, and if not for a whistle blower at Putnam in Boston, it would surely still be happening. None of the funds we currently own have been implicated. While deplorable, this is not a reason to abandon mutual funds. It is a reason to consider other types of securities for a portfolio. Our firm currently holds approximately 40% of client money in individual common stocks, bonds and preferreds. No-load funds remain excellent vehicles to access superior managers in specialized niches. The integrity of our fund managers is extremely important to us. We seek above average performers with below average costs.

Stock Funds – Most of our recent purchases have had an international flavor. With the dollar on the ropes and foreign economies growing, these funds have had a nice tailwind. Our old standby **First Eagle Overseas** has been stellar. The **Matthews** family has done an excellent job is providing direct exposure to the Pacific Rim. New purchases last quarter were made in several funds from the **American Funds** family based in L.A. **Capital Income Builder** and **Income Fund of America** give us balanced exposure by owning both stocks and bonds domestically and overseas. This firm has an extensive global research effort that is focused on identifying undervalued securities. We also established new positions in two stock funds: **Capital World Growth & Income** and the **New World Fund**. Capital World focuses on blue chip dividend paying stocks, while New World delves into emerging markets. The emerging market risk is tempered by also owning U.S. multi-national companies, like **Coca-Cola, Avon Products**, and **Phelps Dodge** that derive a significant portion of their revenue from other countries.

The **Vanguard** group continues to be one of our favorites. *Morningstar* recently honored the management team of **Vanguard Capital Opportunities** and **Vanguard Primecap** by naming them domestic fund managers of the year. Last quarter we increased our position in the **Vanguard Health Care Fund** following the passage of the medicare reform legislation. This removed an obstacle that held back many health care stocks during 2003.

A new sector play for us is energy services. This is another area that did poorly last year and represents a good opportunity moving forward. We believe that demand will improve in this area as major producers revitalize existing fields and explore for new deposits. Indicators suggest that demand for oil and gas will stay firm. Well owners need to make up for several years of deferred maintenance and new fields in Russia represent untapped potential. To access this area we have purchased an exchange traded fund, the **Oil Service Holdrs Trust** (ticker: OIH). The fund holds 18 of the biggest players in this sector.

Fixed-Income – The riskiest bond sectors, high yield and emerging markets were the best performers in 2003. U.S. Treasuries and other high quality bonds, which we underweighted, were the worst performing area. Expect more of the same for 2004 as longer-term interest rates start to ease up later in the year. We acquired a new high yield player last quarter, the **Pimco High Income Fund**, PHK. Pimco is headquartered in Newport Beach and is widely known for their bond fund prowess. This fund holds high yield "junk" bonds and through the prudent use of leverage pays a hefty monthly dividend producing a 9.6% yield. As the economy continues to strengthen, we expect these bonds to perform well. We bought this fund at a slight discount to the net asset value (NAV). **Pimco CA Municipal Income Fund**, PCQ, is another new addition for our clients that prize tax-free income. This fund is also trading a discount to the NAV and paying out over 6% tax-free. The closed-end format of each of these funds prevents new investor money from diluting the high yields. Unlike open-end funds, these funds issue a fixed number of shares that trade on an exchange. The market price will often diverge from the funds' net asset value producing either a discount or premium. We buy when the market price is trading at a discount to the net asset value.

Preferred Securities – What's wrong with 7-8% yields with no stock market risk? Maybe some day when interest rates move significantly higher, preferred prices may come under pressure, but over the last few years they have been the salvation for our conservative clients as a welcome alternative to the paltry interest rates offered by the banks. Many of these preferreds have now traded up over their $25 par value and it has become exceeding difficult to find new ideas that are trading at a discount to par. One holding that qualified last quarter was **El Paso Corp. 7.65%** preferred (PJJ). This company was slammed following the Enron debacle. However, we believe the bad news is priced in and the future looks promising. The company owns and operates the largest natural gas pipeline network in North America. A new CEO took over in the 4th quarter of 2003 and is in the process of making positive changes.

Dividends – Now that dividends from common stocks are 85% tax-free, we expect demand for these securities to be steady in 2004. We own the following S&P 500 companies that have raised their dividend payouts annually for a quarter-century or longer. **Alltel**, **Anheuser-Busch**, **ConAgra Foods**, **General Electric**, **Johnson & Johnson**, **Lowe's**, and **Pfizer**.

Income Tax – We plan to mail realized gain / loss reports to all clients with taxable brokerage accounts by January 31. This information will assist your tax advisor in preparing your 2003 income tax return. If you expect a material change in your income or assets for 2004, please let us know.

Local News – Did you catch the recent article in the OC Register about Financial Advisory Consultants, out of Lake Forest? James Paul Lewis Jr., 57, had a booming business with clients from across the country. A member of the Church of Jesus Christ of Latter-day Saints, he established his practice through church contacts and word quickly spread. He touted, and his statements showed 20 – 40% annual returns with never a down year. The only problem was that it was all smoke and mirrors. Neither Lewis nor his firm was registered as an investment advisor. There was no independent custodian, like Charles Schwab. Lewis started to block withdrawals in June 2003. The Securities and Exchange Commission, who has audited our firm, says the "fraudulent scheme" involved $813 million from more than 5,200 investors.

They are still sorting things out but it appears that most of the money is gone. Walker Financial has been registered as an investment advisor with the SEC since 1986. They periodically audit registered firms to ensure compliance and fair dealing.

We appreciate the opportunity to handle your investment advisory and financial management needs. Please let us know if there is anything else we can do to assist you.

Scott Walker
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