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Continued global gains or time for a pause to refresh?

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With no end in sight to the war in Iraq and President Bush's approval ratings dropping to all-time lows, equity markets chose to focus on strong corporate profits, low interest rates, and a soft landing for the economy with hopes for a Fed rate cut in '07. Both stocks and bonds rallied last quarter to near record highs. Investor sentiment has turned more bullish, so from a contrarian standpoint this increases the likelihood of a near-term correction. Given the large recent gains, it would not be surprising to see us give some back in the months ahead, but with valuations still reasonable we look for 2007 to be another good year.

Our targets have always been modest knowing that stocks have historically returned about 10% annually since 1926. With risk free returns of 5% available in the short-term money market arena, we're happy with returns in the 7- 10% range for the majority of our clients with a balanced moderate risk portfolio. At 7.2%, our money doubles every ten years. I am happy to report that across all managed client accounts we were up a net 13.28% for the past year, and 9.17% annualized over the past three years. 2006 was an above average year and we'd like to remind clients to maintain realistic expectations moving forward.

Your returns will vary depending upon your entry date, asset allocation, risk tolerance, and need for income. Warren Isenberg and myself work together to preserve and grow your capital. We eat our own cooking as demonstrated by the fact that we personally own many of the same securities found in your accounts.

Is all the good news discounted into current prices? Rather than attempt to time the market and exit stocks, we espouse an asset allocation strategy incorporating different asset classes to reduce risk. By blending different asset classes and types of investments, we reduce portfolio volatility while still generating good returns. We may miss a bit of a big move up in stock prices, but when times are tough we'll have better downside protection, while also earning interest and dividends on many of our holdings. Check out your color asset allocation pie chart for the different types of investments in your portfolio.

For taxable brokerage accounts, remember that a portion of your gain will be non-taxable. Price gains on securities are not taxed until sold, with the exception of mutual fund dividend distributions. Mutual funds are required to pay out all dividends and realized gains annually to avoid tax at the fund level. These distributions accrue into the share price throughout the year, and can result in large year-end distributions following a good year in which the fund profitably sold stocks. This is why you may have seen your stock fund share price drop 10% in one day last December. On that day the fund went "ex-dividend" and paid out the annual distribution. We reinvest stock fund distributions, so you received more shares purchased at the lower price. Our system tracks these distributions and automatically increases your cost basis by the amount of any reinvested dividends.

Growth Investments – Stock mutual funds posted impressive returns with international stock funds leading the way for another year with 20%+ gains for 2006. Foreign funds have been part of our allocation for years, and we took advantage of the strength last year to rebalance many client accounts and trim off some profits to reduce risk. However, we continue to believe that holding a meaningful percentage of your equity exposure overseas makes sense. Our core international holdings favor a more conservative posture versus a pure emerging markets fund. We have stacked our deck with actively managed funds emphasizing a value approach built from the bottom up, one stock at a time.

Charles de Vaulx, manager of **First Eagle Overseas** states “managing risk is what our endeavor is all about.” Some of the ways the fund manages risk are: 1) Ignoring benchmarks which are often the most overweight in sectors or countries where securities have gone up the most in price. 2) By being multi-cap oriented and flexible to go where they believe the best opportunities lie. 3) Having a willingness to hold cash whenever they cannot find enough securities at prices they like (the fund currently has 23% in cash). 4) A willingness to hold securities for a long time (3-5 years), particularly if the underlying companies have good businesses and a decent competitive position. 5) By worrying a lot about what can go wrong, whether at the individual security level, sector or geographic level or at the more macro economic level. With that kind of diligence, we are comfortable holding First Eagle in any environment.

One of our favorite large cap U.S. growth stock managers, PRIMECAP Management Company, LLP out of Pasadena, manages three **Vanguard** funds that we own: **Primecap**, **Capital Opportunity**, and **Primecap Core**. The first two are currently closed to new investors, so we have been adding Vanguard Primecap Core to newer accounts. The managers remain enthusiastic about technology and health care companies. We concur with four major trends they see driving demand for tech companies into the future: (1) the availability of inexpensive bandwidth as broadband penetration among U.S. households doubles from 40%; (2) the sharing and storage of digital information, such as photos, data files, music, and video; (3) the convergence of voice, data, video, and wireless services; and (4) the need to protect and secure data and identities.

In addition to the Vanguard stock funds, for clients willing to assume more risk, we own and continue to like **Qualcomm** (QCOM), **Cisco Systems** (CSCO), **Microsoft** (MSFT), and **Yahoo!** (YHOO). Continued productivity gains from technology applications bode well for corporate profits and economic growth in the years ahead.

Fixed-Income Securities – During the last quarter, bonds, bond funds, closed-end bond funds, and preferred stocks all rallied in price as inflation concerns dissipated with declining oil & gas prices and increased expectations that the Federal Reserve would cut short-term interest rates by mid-2007. Given the recent high prices, it has become increasing difficult to find attractively priced fixed-income securities, so we have allowed cash to build up. There will inevitably be sell-offs in the months ahead that will provide opportunities for us to buy at more favorable levels. We had the good fortune last quarter of having two of our preferred stock issuers become the target of acquisitions. **Tommy Hilfiger** was taken private, so our 9% preferred was redeemed at par. **Truststreet Properties** was acquired by GE Capital, and our preferred jumped in price on the news to just under $25 par value. Both securities notched an 18% gain for the most recent quarter.

One new type of bond we began purchasing last quarter is structured notes, or reverse convertibles. Reverse convertible notes (Recons) are higher-coupon, short-maturity securities with characteristics of both bonds and common stocks. These notes have maturities of 6 months to one-year, pay interest monthly or quarterly, and provide higher yields than traditional bonds in exchange for some of the risks of owning a specific common stock. Unlike owning common stock, Recons offer some downside protection against a decrease in the value of the common stock.

For example, one new issue we purchased in December is linked to Qualcomm (QCOM). Maturity is one-year; coupon is 12% payable quarterly. Downside protection is 20% below the closing stock price on the fixing date, 12/27. So let's assume the price of QCOM on the fixing date is $40/share. 20% off that price is $32/share, so $32 is the barrier price.

As long as the price of QCOM does not breach the barrier price, we receive our principal back in cash at maturity. If the barrier price is breached and the stock subsequently rallies back above the fixing price of $40, we receive our principal back. Only in the event that the barrier price ($32) is breached and the stock price is below the fixing price ($40) at maturity, do we stand to lose money. In that event, we receive shares of QCOM common stock plus our interest payments. The key is buying notes linked to stocks where we judge the downside to be limited.

Lehman Bond Update – Over two years ago we purchased a variable rate note issued by Lehman Brothers Holdings for several clients. We did not anticipate that the Fed would boost short-term rates 17 times to their current level, so the variable interest rate formula has worked against us, and the price of the bond has been marked down to 85, or 15% below par value. The issuer remains in excellent financial shape, so rather than sell at the current depressed price, we are holding knowing that the variable rate formula is likely to sway back in our favor. If this comes to pass, the bond may be called early or redeemed at par in a couple of years. Worst case is that we hold until final maturity in 2014, but the interest rate formula gets increasing attractive for us in the years ahead.

Costs – Since we are paid based on your account value at the end of each quarter, we endeavor to minimize your costs of investing whenever possible. We use only no-load mutual funds, or in the case of load funds, we purchase shares at the net asset value without the load. We like low expense ratios on our funds, but will make occasional exceptions for outstanding management (like David Winters with the Wintergreen Fund). We will pay Schwab a transaction fee for some mutual funds, like Vanguard, where the fund company refuses to pay Schwab. When we buy or sell individual securities, we pay Schwab a one-time trading commission. After that, there is no on-going carrying cost to stocks or bonds. We calculated the total costs paid to Schwab in 2006 for all clients and divided that total into our asset base. The result is that Schwab costs averaged only .03% for the year. At the end of the day, your total return after all fees and costs is what counts. That is what we report to you each quarter on your portfolio performance review.

Cash Invested – Upon close examination of your portfolio statement, you may notice that the cash invested number for certain holdings is different than the amount originally invested. The reason is that we now subtract out any partial sale proceeds from your original cash investment to arrive at the cash invested amount.

2007 Retirement Plan Contribution and Deferral Limits:

For those still generating earned income, get a jump on your 2007 contribution and accelerate the compounding in your retirement account.

IRA and Roth IRA - $4,000 / $5,000 with catch-up (for those who reach age 50 in 2007); 401(k), 403(b), 457 Plan Employee Salary Deferral - $15,500 / $20,500 with catch-up; SEP IRA - $45,000; Defined Contribution Plans (profit-sharing, money purchase pension plan) - $45,000 including any salary deferral, ($50,000 with age 50 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-favored basis for the future. Looking for a tax-free gift for a child or grandchild? If they have earned income, set up a Roth IRA account in their name and instill a savings ethic for their future.

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