Review, Outlook and Opinion January, 2009

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Navigating Rough Seas – The past year has not been fun as the economy and stock markets worldwide fell off a cliff. Fed chairman Bernanke and his colleagues have been working overtime to pull out all the stops and flood the system with liquidity to avoid the early 1930's policy mistake of restricting credit and tightening money supply. In an effort to get the credit logjam moving, Fed officials cut the short-term Fed funds target interest rate to a record low of 0 – 0.25%. In conjunction with the Treasury department, the U.S. government has doled out approximately $350 billion to banks in exchange for preferred stock. All the major investment banks have converted to bank holding companies and gotten in line for federal assistance. The new Obama administration is committed to a huge stimulus plan to reinvigorate the economy, and eventually we will crawl out of this mess.

Calmer Waters Ahead – We are now in the midst of a deleveraging process as consumers and corporations scramble to pay off debt, which becomes more costly in a low interest rate deflationary environment. Stocks closed out 2008 with the S&P 500 down 37% for the year, the worst showing since 1931. International stock funds fell harder, so it was good that we sold most of our holdings in that area during the summer. We were early reinvesting some of the sale proceeds in some U.S. stocks during August and September. However, stock prices put in a recent bottom on November 20, and have made some upward progress since then. Is this a cyclical bull market move in a secular bear market that started in late 2000? No one disputes that there are many bargain stocks available today, and acquisitions made this year will likely look good three to five years from now. It's the next year or two that will be tricky. It's smart to stay balanced with plenty of high quality bonds and cash reserves to smooth out the bumps, while selectively adding to equities at bargain prices.

Last year's winners were mainly cash equivalents like money market funds, Treasury bills, and FDIC insured certificates of deposit. The only problem is that yields have collapsed to less than 1-2%, but your share price and principal are stable. Keep two years of your cash flow requirements in cash for safety. Beyond that, a laddered bond portfolio can provide cash as bonds mature each year. Stocks are for the long haul, like real estate. Subtract your age from 100, and that's the percentage to target for stocks. So someone age 70 would have a 30/70 allocation, with 30% in stocks. Adjust accordingly for based on personal preference.

If you have fears regarding stocks, please read the attached article from Warren Buffet which was published in the New York Times last October. Feel free to call or email if you would like to review your target allocation.

We underestimated the extent to which security prices might decline as our over leveraged economy rolled over. We have taken a hard look at our holdings, and have chosen to reduce our exposure to actively managed mutual funds. Why pay the higher expense ratios associated with actively managed funds when we can buy an exchange-traded fund (ETF) at a significantly lower cost? If the active fund manager has a history of beating their benchmark or some special attribute, we can build a case for paying a higher management fee, but those managers have become exceeding rare. ETF's have lower costs, greater transparency, and we have the ability to buy and sell throughout the trading day, whereas mutual funds price once at the end of the day. We are not abandoning all actively managed funds, but will increasingly look to ETF's for new buys.

To control downside risk we have always espoused an asset allocation approach where we structure a portfolio based on the clients' needs and risk tolerance level. It has generally worked well and served to limit our losses to approximately ½ the drop incurred by the broad stock indexes. However, we are expanding our risk controls for individual common stocks to cut losses and limit exposure to adverse price movements. Unless you have made special arrangements with us, we will place stop loss orders to sell any stock that drops 10-15% below the recent year end price. New holdings will have stops set 10-15% below the purchase price. This new policy will serve to limit losses and can also be used to preserve gains after the price advances. If a stock drops 20%, you must gain 25% to get back to even; but if a holding drops 40%, you must produce a 67% gain to break even. Sometimes we make mistakes, and sometimes the market turns nasty. Cutting losses at a pre-determined point means that you will have a good portion of your capital intact to fight the next battle and guards against a potentially crippling larger loss.

<u>Exchange Traded Funds (ETF's)</u> – Over long periods of time, small company stocks have historically produced the highest returns. So we're looking to buy the **iShares Russell 2000 Value Index** (IWN) on price weakness. **Dow Diamonds** (DIA) is a core ETF we are looking to acquire on a pull back. This fund owns the 30 stocks in the Dow Jones Industrial Average and over various time periods has outperformed the **SPDRs** (SPY) which tracks the S&P 500 stock index.

Sector ETF's we own include the **SPDR Gold Shares** (GLD) as a direct play on the price of gold bullion. This ETF actually owns 400 oz. bars of gold and is priced at 1/10 the price of an ounce of gold. Given the large cost of the bailout and escalating national debt, the long-term value of the dollar is in jeopardy. The huge fiscal and monetary stimulus needed to reflate the economy could have inflationary implications downstream. Gold acts as an insurance policy against the debasement of paper currencies and is an excellent inflation hedge.

Energy prices have collapsed but we do not believe the move is over for commodity and natural resource shares. The **Energy Select Sector SPDR** (XLE) provides exposure to the majors and the equipment and service companies. We also continue to like the **PowerShares Water Resources Portfolio** (PHO) as the world population continues to expand. This ETF owns companies in the Palisades Water Index. The **United States Natural Gas** (UNG) tracks the spot price of natural gas, our domestic clean burning fossil fuel. The slower economy is affecting demand during the winter which is traditionally a good time to own the commodity.

<u>Common Stocks</u> – We have always liked dividend-paying blue chip stocks and believe their dividends will become more prized as we wade through the marsh waiting for the muck to subside. The demand for health care is steady despite a weak economy, and **Johnson & Johnson** (JNJ) is the stalwart that has increased their dividend annually for the past 45 years. **Express Scripts** (ESRX) is a pharmacy benefits manager serving health plan providers. They negotiate lower drug costs for consumers and encourage the use of generic drugs. **Allergan** (AGN) is a local Orange County company that recently received FDA approval to market Latisse eye drops as a treatment for eye lash hypotrichosis. Glaucoma patients using the drops had reported thicker lashes. Anti-wrinkle botox and juvaderm continue to sell well, as does the lap band diet product.

Do you know consumer staples stock that produces Pampers diapers, Tide laundry detergent, and Crest toothpaste? All three brands and many more are owned by **Proctor & Gamble Co.** (PG), a Dow 30 component with an outstanding record of annual earnings and dividend increases. Last year they acquired Gillette and their Duracell battery division.

Technology bellwether **Hewlett-Packard Company** (HPQ) has undergone a big transformation since Mark Hurd became CEO two years ago. We can personally attest to the high quality and dependability of their laser printers. The ink cartridges provide a steady stream of recurring revenue, and the recently closed EDS acquisition will bolster HPQ's competitive position against IBM. There are better days ahead for San Diego based **Qualcomm** (QCOM), which remains the leader in 3G wireless technology.

FPL Group, Inc. (FPL) is Florida's largest public utility that also operates unregulated business units that are leading the charge toward more green alternatives like solar and wind power. Traditional carbon fuels will continue to be with us for many years, and stocks like **Chevron** (CVX) or **Exxon Mobil** (XOM) are two of the biggest and best.

President-elect Obama is talking up infrastructure spending, so we're looking at **Fluor** (FLR) the global engineering and construction firm, **Deere & Co.** (DE) the Moline, IL farm equipment maker, that also has a road construction business, and **Caterpillar** (CAT) the granddaddy of heavy equipment.

Retailers have been crushed, but those offering a value proposition like **Costco** (COST) and **Pricesmart** (PSMT) are still growing. Stocks discussed may not be appropriate for all client accounts. Client holdings will vary based on individual objectives, different inception dates and manager discretion.

Stock Funds – Stick with **Vanguard Primecap Core** and **Capital Opportunities** for the inevitable rebound in U.S. growth stocks. **Matthews Asian Growth & Income** is our top international pick due to its lower risk score and exposure to the Pacific Rim. Despite the economic slowdown, the Asian countries will continue to offer the best growth in the world. They have budget and trade surpluses, a strong work ethic, and a culture that values personal savings. We are staying with David Winters and the **Wintergreen Fund** for now. The fund had very disappointing results last year, so he is on a short leash and we are closely monitoring his progress versus other alternatives.

Bonds / Fixed-Income Investments –The flight to safety has pushed yields on U.S. Treasury securities (bills, notes, and bonds) to record low yields and record high prices. After two great years, long-term Treasury bonds may be the next bubble to blow when the economy begins to recover. Alternatively, good value exists in high quality corporate bonds which were unduly punished as the credit crises escalated. We recently purchased short-term notes maturing in 1-2 years issued by **JP Morgan Chase**, **Goldman Sachs**, **GE Capital**, **Exelon**, and **Kraft Foods**. Yield to maturity was in the 4-5% range for investment grade paper. The U.S. government has invested in the financial names, and that's a good partner to have. For more diversified exposure, we have increased our position in the **Vanguard Short-Term Investment Grade Bond Fund** (VFSTX) for a lower risk 4.8% yield. The **Metropolitan West Total Return Bond Fund** (MWTRX) dipped in price, but has turned the corner and the 5.9% yield is competitive with intermediate maturity alternatives. Both of these actively managed funds have long-tenured managers that have proven their worth.

Municipal bonds had a hiccup last quarter, but have seen their prices stabilize and move higher in December. The State of CA is scrambling to put together legislation that Governor Schwarzenegger will sign to deal with billions of red ink projected over the next year. Some are saying that CA may run out of cash as early as February 1st. The State has been unable to tap credit markets for the money due to the lack of buyers given the uncertain environment. Outstanding CA municipal bonds recently caught a bid after a couple months of gradual price erosion. When the Feds bailed out Fannie Mae, the bond holders were made whole, and we believe the same would be true with the State of CA if it came to that point. We have maintained our laddered portfolios of individual municipal bonds for their tax-exempt interest. The ladder has bonds maturing in different years and is a proven method for coping with interest rate risk. The best CA municipal fund is the closed-end **Nuveen CA Select Tax-Free Income Portfolio** (NXC). The fund has no leverage, low expenses, and the monthly dividend produces a 5% tax-free current distribution rate. Municipal bonds are liquid marketable securities with tax-free interest, unlike annuities where the interest is merely tax-deferred, and access to your funds may be limited or subject to a surrender charge.

The **Global High Income Fund** (GHI) is a closed-end fund that invests in emerging market bonds. Along with high yield junk bonds, the emerging market bonds have been hammered. We sold all our junk bond funds before the big drops and parked the sale proceeds in cash, but we chose to hold our shares in GHI. This diversified fund now sells at $8.50 which is a 15% discount to the $10/share net asset value. The other attraction is the juicy monthly dividend which is 9% of the net asset value.

Preferred Stocks – These securities were marked down in price last year as credit spreads widened amid the flight to safety. Dividends continue to be paid and the lower prices have given us an opportunity to pick up some quality merchandise at bargain levels. The housing melt down has necessitated that many people downsize and place belongings in storage, which has kept demand steady for self storage units. As a conservative way to participate, we purchased the **Public Storage 7.50% cumulative preferred, Series V** (PSA+V) at a discount to the $25/share par value.

Who did the Federal government call when they needed a strong bank holding company to step in and avert a takeover of Merrill Lynch? **Bank of America Corporation** (BAC) and Ken Lewis, CEO got the call and recently closed on the acquisition. They may be forced to cut their common stock dividend again, so we prefer the trust preferred **BAC Capital Trust I, 7.00%** (BAC+W), dividends paid quarterly, current price $20.85 for an 8.4% current yield. Trust preferred securities are treated as company debt, so they rank above common and preferred stock, and would be paid off before common and preferred stock holders in the event of company liquidation.

Income Taxes – For clients with taxable brokerage accounts, we will be mailing your realized gain/loss report during the last week of January. Our report will provide original purchase date and cost basis information to supplement the Schwab 1099. These two documents will give you everything necessary to report sales that occurred in your account during 2005. As always, we suggest you defer filing your income taxes until early March to avoid having to amend your return, as Schwab may be required to issue a corrected 1099. We are happy to speak directly with your accountant to coordinate strategies to minimize income tax.

Thanks for the trust and confidence. We are working hard to continue to earn it.
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