Investment Review & Outlook January, 2010

By: Scott Walker, CFP

A year ago, stocks were in the midst of the worst bear market since the early 1930's. With the economy in recession and mortgage defaults mounting, stock prices bottomed on March 9, and have since recovered to near 52-week highs, but remain well below all-time record high levels reached in 2007. Corporate America is lean with low debt and earnings poised to turn higher. The majority of fundamental and technical indicators continue to be bullish. There is always an element of uncertainty and risk with equity investments which is why we espouse balanced portfolios for most clients where we hold stocks for growth and dividends, and bonds for income and safety. Cash is a residual asset to keep some powder dry.

Your asset allocation is the key driver of volatility and returns. We are ever mindful of the downside risk, but take comfort in the overall high quality of our holdings. For 2009, our annual average return across all client accounts was 21.2% net of fees. 2010 is likely to be more challenging, but we continue to hunt for good opportunities to add value in both the stock and bond markets. If you have questions regarding your portfolio, or have other funds you may wish to consolidate at Schwab, please call or email.

Schwab Brokerage Commission Reduced – Effective January 19, 2010 Schwab Institutional clients who are enrolled in electronic delivery of confirms and statements will see stock brokerage commissions reduced from $12.95 to $8.95 per trade. If you are not yet enrolled in e-delivery, please contact our office.

Schwab Tax Reporting – February 15th is the tax-mailing deadline for Schwab to issue your 1099 that is also reported to the I.R.S. Walker Financial will also send your cost basis and expense report. Our management fee may be fully or partially tax deductible to you. Your cost basis information may also be found on-line at www.schwaballiance.com. Next year, Schwab will have all the information listed on the 1099. We review all taxable accounts for tax-loss harvesting candidates prior to each year end in order to minimize taxable capital gains.

New IRA Law – Roth IRA's are the premier tax-advantaged accounts. Once you've had a Roth IRA for five years, all distributions from it are tax-free as long as you are at least 59 ½ years old. Regular distributions from a traditional IRA are taxable, and vulnerable to any increase in tax rates. In addition, Roth IRA's are not subject to required minimum distributions (RMD's) as opposed to regular IRA's where money must be distributed annually after age 70 ½.

A new law became effective January 1, which removes the income restrictions for converting a regular IRA to a Roth IRA. For those not planning on tapping into their regular IRA in the near future, converting all or a portion of your regular IRA may be a viable strategy. Old 401k accounts may also be candidates for Roth conversions. For conversions done in 2010, you have the choice of paying the tax due in 2010, or deferring the income recognition to 2011 and 2012.

With tax rates probably going higher, we may want to take the tax hit in 2010, assuming our overall income level is constant. In order to make the strategy work, the income tax should be paid from funds outside the IRA.

Annual contributions to Roth IRA's are allowed for those with earned income; however high income earners are still prohibited from making annual contributions. Give us a call if you'd like to discuss your options.

Equities – The earnings yield on dividend-paying stocks stacks up very well against today's low bond yields. We build portfolios with diversified industry exposure, and currently hold securities in consumer staples, energy & natural resources, financials, health care, retail, technology, and utilities. We own best of breed individual stocks, exchange-traded funds (ETF's), and some traditional open-end funds. Risk is controlled by limiting our exposure to any sector to 15% of the total portfolio. International and emerging market stocks have been on fire, so we are reluctant to add additional exposure at this time, with the exception of the Matthews Asian Growth & Income Fund, with its lower-risk profile.

Consumer Staples: Proctor & Gamble (PG) products are sold in more than 180 countries. Premium quality brands like Gillette, Duracell, Tide, Crest, and Pampers are some of the 23 brands that generate over $1 billion each in annual sales. This dividend achiever has boosted their dividend for the past 55 consecutive years, for a 2.9% current yield, and a 17% return on equity.

Energy & Natural Resources: The Energy Select Sector SPDR, (XLE) is an ETF that holds all the big integrated majors along with equipment and service companies. Chevron Corp., (CVX) is experiencing some short-term pressure with refining margins but has a global presence and a diverse production base, 3.4% current yield. We were fortunate to own some XTO Energy, Inc., (XTO) which bolted higher in December when Exxon Mobil announced a $41 billion purchase agreement. XTO is a big player in natural gas, specifically extracting gas from shale rock formations. Ultra Petroleum Corp., (UPL) has a similar but smaller profile than XTO, and is known for their industry-leading low costs. Cold winter weather is also benefitting natural gas producers.

Holding gold bullion is the ultimate hedge against the debasement of paper currencies. It's easy with the SPDR Gold Shares (GLD) for direct exposure to bullion. This ETF has reasonable expenses of 0.40% and holds gold bars which track the price of gold. We like Barrick Gold Corp. (ABX) with a treasure chest of 26 operating mines and a pipeline of projects across five continents. They have the largest gold reserves in the industry.

Financials: This area was weak in the 4th quarter, which gave us an opportunity to increase exposure. Big banks continue to rebuild capital and last quarter Wells Fargo & Company, (WFC) was able to repay their TARP bail out money to the government as they continue to digest the Wachovia acquisition. We recently added to our position in JP Morgan Chase & Co, (JPM). CEO Jamie Dimon is widely regarded as one of the best in the business. JPM was the first to repay government TARP money and is exerting more of a West coast presence with their

Washington Mutual purchase. The company slashed their quarterly dividend by 87% last February to a nickel a share (0.50% yield) from 38 cents. Dimon would like to pay 80 cents annually and there's a good chance this bank will be the first to boost their dividend later this year.

Berkshire Hathaway, (BRKA & BRKB) operates as a holding company with major insurance operations and is headed by Warren Buffet, the oracle of Omaha. He recently engineered announced a deal to buyout Burlington Northern Santa Fe. In order to consummate the transaction, the Class B shares will be split 50 to 1. Based on the underlying businesses and other investments held, we believe the B shares have a current pre-split intrinsic value of $5,000/share.

Health Care – The threat of adverse legislation in Washington has caused this industry to lag in the rebound, but with a bill now being hammered out in conference committee, the bad news appears to be priced in. Favorable demographics coupled with reasonable valuations lead us to increase our exposure with the T. Rowe Price Health Sciences Fund. The portfolio manager is a physician that invests 100% of his retirement money in the fund. He has a good mix of small & mid cap biotech stocks, medical device makers, generic drug plays, and cost containment pharmacy benefit managers. We also continue to hold our long-time stalwart, the Vanguard Health Care Fund. This low-cost leader is lead by Ed Owens who has been at the helm since the fund's 1984 inception.

Johnson & Johnson, (JNJ) is our largest stock holding in this industry, and is a dividend achiever with 46 consecutive years of dividend increases, for a 3.0% current yield, and a 30% return on equity. Allergan Inc., (AGN) is our local Orange County multi-specialty company with an emphasis in dermatological and eye care products.

Retail / Consumer Discretionary – Costco Wholesale Corp., (COST) is our biggest position in this sector. Pricesmart Inc., (PSMT) has a similar business model with membership warehouse clubs in Central America, the Caribbean and the Virgin Islands.

Starbucks Corp., (SBUX) has turned around since Howard Schultz, the founder returned as CEO. The company has been closing stores and has introduced Via a new instant coffee that is also being distributed through Costco and Target. In addition, the company's Seattle's Best brand will be featured in 9,000 Subway sandwich shops.

Buckle, Inc. (BKE) is headquartered in my home town of Kearney, Nebraska. I worked at their original store stocking and selling clothes during the summer of 1978. The merchandise was marked up 100%, and then we would have 20% off sales. BKE now has stores in 39 states and operates with no debt, trades at a 12 P/E, 2.5% yield, and 31% return on equity. Dan Hirschfield and Dennis Nelson still run the company from Kearney and own over 40% of the stock.

Technology: Google, (GOOG) and Qualcomm, (QCOM) are our top holdings as their internet and wireless initiatives continue to enhance personal and business productivity around the world. Cloud computing is the wave of the future where companies access remote servers from any location and can minimize capital costs for hardware and software upgrades. International Business Machines, (IBM) is a big player with large corporate and governmental customers in the U.S. and overseas.

Utilities: This sector was a laggard last year, but valuations are favorable and owning some defensive issues will prove beneficial when we hit stormy weather.   A new holding for us is NRG Energy, Inc. (NRG). This wholesale power generator grew revenue 12% last quarter and is making big strides in renewable energy. Last quarter NRG acquired the largest photovoltaic solar project in California. Electricity generated by the Blythe project is being sold to So. CA Edison under a 20-year power purchase agreement. We also own Florida powerhouse, FPL Group Inc., (FPL). The growth catalyst is their Next Era Energy unregulated alternative energy subsidiary. A dividend increase last March, gives us a 3.6% current yield.

Bonds – Bonds will always have a place in a diversified portfolio, but with record inflows into bond funds and prices on most issues up strongly, we are being very selective with new purchases. Building a high-quality bond ladder so you have bonds maturing in different years is what we do. Your principal is returned at maturity, so we're able to reinvest on a different step on the ladder. We added a prime broker relationship with a municipal underwriter in L.A. that allowed us to participate in a recent offering of tax-exempt bonds from the City of Mission Viejo. Stone & Youngberg continues to be our primary resource for new issue bonds, as they underwrote the Moulton Niguel Water District bonds we recently purchased.

There was big local bond fund news last quarter, as our long-time favorite managers with Metropolitan West agreed to merge with TCW in Los Angeles. We are closely monitoring developments, but Tad Rivelle, Laird Landman, and Steve Kane continue to lead the Met West team. In addition to our core holding Met West Total Return Fund, we have added the Met West Low Duration Fund. Vanguard Short-term Investment Grade Bond fund is our other low risk bond fund. Global High Income (GHI) gives us exposure to emerging market bonds.

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

January 13, 2010