## Review, Outlook, and Opinion January, 2011

**By: Scott Walker, CFP**

Risk taking was rewarded for a second consecutive year with stocks and gold posting double digit returns. Bonds also made money for the year, despite encountering head winds last quarter. Cash yields are nailed to the floor by a 0 – 0.25% target Fed funds rate, with no hikes in sight until 2012 at the earliest. The Federal Reserve is still in a very accommodative mode and has committed to purchase $600 billion of U.S. Treasury securities in an effort to juice the economy and hold down interest rates. Congress and President Obama have also greased the slide by extending the Bush tax cuts for another two years. Our national debt now totals $13 trillion.

We continue to recommend a balanced portfolio with varying degrees of equity exposure based upon a blend of your risk tolerance and our assessment of the financial markets. The key is to own best of breed, keep expenses low, and not chase recent past performance. Across all client accounts, we ended the year with 45% invested in equities, and posted a net average total return of 10.16% for 2010. Check out your portfolio performance report to view your returns.

Our most conservative bond focused accounts struggled last quarter as higher interest rates exerted downward pressure on bond prices. We avoided most of the damage with an emphasis on short to intermediate maturities, mortgage-backed securities, and foreign bonds. Municipal finances, especially the State of CA, are being called into question as we face a projected $25 billion deficit for the next fiscal year. A recovering economy will help, but more action is needed. We sold all of our CA municipal bond funds earlier last quarter at higher prices to lock in profits. We continue to hold many individual municipal and corporate bonds and maintain a high degree of confidence that our principal will be returned at maturity.

The environment looks to be favorable for the road ahead with continued low interest rates and business improving for most companies. However, the overall level of debt in the developed world is worrisome. High debt to GDP ratios plague many developed countries and bear watching in Europe. Bullish investor sentiment, a contrary indicator, has shot up as stocks have rallied, so that gives us pause when looking to invest new cash at this juncture.
The good news is that corporate balance sheets are in good shape, sales and earnings are growing, and valuations are decent on select large cap stocks. Remember that stocks can and will go down, so rather than sell them all at the first sign of trouble and attempt to time the market, we manage risk one holding at a time, and counterbalance the stock market risk with bonds, bond funds, gold, and cash.

**Bonds & Bond Funds** – The weather turned nasty last quarter in bond land, with few shelters from the storm. The benchmark 10-year Treasury yield finished the year at 3.30%. This compares to 3.99% a year ago, but is well above the 2010 low of 2.38%. Rates moved lower through the end of October as investors anticipated additional liquidity injections from the Fed. When quantitative easing round two was launched in early November, the bond market reversed course as longer-term interest rates shot up. We continue to avoid longer term bonds where the interest rate risk is highest, and have no exposure to Treasuries. Our strategy is to be opportunistic and hold a mix of unique bond funds, along with a ladder of individual bonds with short to intermediate maturities.

Foreign bonds denominated in local currency will hedge the risk of an all dollar U.S. based bond portfolio. Michael Hasenstab PhD, the lead global bond manager at Franklin Templeton, was just named Morningstar fixed-income manager of the year. We are able to access his open-end fund at no-load through the **Templeton Global Bond Fund**. He also manages a pair of closed-end funds (GIM & TEI) that are appropriate for more risk tolerant accounts. He emphasizes bonds from countries that have improving fundamentals and low debt to GDP ratios. Many emerging markets are in better financial shape than more mature developed markets (think Greece, Ireland, Portugal, and Spain). Hasenstab has sizable stakes in government bonds from South Korea, Australia, and Brazil, and is defensively positioned with a 2.6 year duration.

The **Doubleline Total Return Bond Fund**, lead by Jeffrey Gundlach is now our largest fixed-income investment. Specializing in mortgage-backed securities, this new fund had an excellent year and still represents the most undervalued area in fixed-income for 2011. Duration is only 3.1 years.

Short-maturity bond funds have low interest-rate risk, and are good defensive holdings. We own the **Vanguard Short-Term Investment Grade** and **Met West Low Duration Bond Fund**.

**Build America Bonds (BAB's) –** These are federally taxable municipal bonds designed to assist state and local municipalities and school districts. Issuers were entitled to a 35% federal rebate for the interest cost on the bonds, which allows them to offer a higher interest rate to investors. The BAB program for new issues expired on 12/31/10, and was not renewed by Congress. All existing BAB's will continue to receive the subsidy for the life of the bonds.

**Equities** – Please note that your holdings may not include all securities discussed due to different client start dates and stock price patterns. We believe in owning individual common stocks along with low-cost mutual funds and ETF's. The largest contributors to our results last year came from the consumer non-discretionary area as retailers saw business improve from depressed year-ago levels. **Costco**, **PriceSmart**, **Buckle**, and **Starbucks** were standouts for us. With oil now at $90/barrel, energy and commodities rallied, so **Chevron**, **Exxon Mobil**, **Barrick Gold**, and the **SPDR Gold Trust** were good to own. **Berkshire Hathaway** ended the year up 22%, and **Dupont De Nemours & Co.** is riding the rebound in demand for industrial materials. Our tech holdings were mixed, with **IBM**, **Microsoft**, **Qualcomm**, and the **Rydex S&P Equal Weight Technology** ETF posting gains, while **Google** finished off 4% for the year. Automakers rebounded, so **Toyota Motor Corp.** is on the road to recovery.

Detractors from performance last year included utilities, especially independent power producer **NRG Energy**. Health care was under the cloud of federal legislation, so **Johnson & Johnson** and **Teva Pharmaceutical** sat out the rally. The **T. Rowe Price Health Sciences Fund** bucked the trend with medical device and biotech stocks picking up the slack. Natural gas prices continued to languish, but **Ultra Petroleum** will have their day in the sun. Financials were mixed with **Wells Fargo & Co.** posting a 15% gain, while **JP Morgan Chase** and **Visa** brought up the rear.

Large cap dividend paying blue chip stocks look to represent the best value moving forward, after lagging their small and mid-cap peers last year. These stalwarts are a lower-risk way to play the growth in emerging markets due to their significant overseas earnings, with foreigners clamoring to buy American brands. Consumer staples king **Proctor & Gamble** fits the bill along with many of the names mentioned above. Many of these companies increased their quarterly dividend in 2010, and have a history of boosting payouts on an annual basis, which gives shareholders a built in raise with inflation protection.

Congress passed the Dodd-Frank Financial Reform Act last summer, but many regulations to implement the provisions have yet to be finalized. We have established a new position with Visa, Inc. The stock sold off due to concerns regarding a provision in the new law to cap domestic debit card fees. The company will continue to benefit as more consumers gravitate to plastic for convenience and reward points. Visa operates the largest electronic payments network in the world and is the #1 provider of credit and debit cards. Visa makes money from three primary sources: 1) Card issuers, usually banks, pay service fees for use of the Visa brand and its global payments network. 2) Transaction or data processing fees paid by banks fall in the 5-12 cent range per transaction. 3) International transaction fees for converting foreign currency. Visa currently generates 40% of revenue from abroad, and projects by 2015 that number will grow to 50% as the paperless global economy continues to expand.

**Gold** – The precious metal continued to glitter by hitting an all-time record high of $1,412/ounce in late December. The rationale for continuing to own gold is that governments cannot devalue gold as they can a currency through the issuance of credit and paper money. Supply is limited, and demand has been steady from global central banks, sovereign wealth funds, and other institutional investors. Precious metals was a top performing sector last quarter, with the SPDR Gold Trust (GLD) ending the year up 29%. GLD is backed by gold in London vaults and tracks the price of gold bullion. Strong inflows boosted 12/31 assets in GLD to $56 billion making it the largest ETF in existence. After ten consecutive up years, the price of gold has turned lower since the beginning of 2011, as investors sold to cash in gains. We opted to sell a portion of our GLD position to lock in profits, believing that it has become a crowded trade and that a correction is overdue. We would not be opposed to buying back the shares at a lower price.

**International / Sector Funds** – Rather than chase the hottest single country emerging markets fund, we prefer to invest with the Matthews fund family for targeted exposure to Asia. Their lowest risk fund has always been the **Matthews Asia Growth & Income Fund**, which holds roughly 65% equities and the remainder in fixed-income securities. Last quarter we expanded our holdings by purchasing the **Matthews Asia Dividend Fund**. Compared to its sibling, the new fund has double the weighting in Australia and Japan, more small caps, and a larger percentage in consumer stocks which will benefit as incomes increase in the region.

**<u>Tax Update</u> –** Our lame duck Congress passed legislation in December, which was subsequently signed by President Obama to extend many favorable income tax provisions for two more years. Highlights include extensions of the 2010 income and capital gains tax rates, and a patch for the alternative minimum tax (AMT) that prevents it from applying to millions of additional taxpayers. Also, new estate tax rules for 2010 provide a $5 million exemption, with a 35% rate, and inherited assets getting a stepped up cost basis. The 2012 exemption will be indexed. In 2013, the exemption is scheduled to fall to $1 million with a 55% top rate, unless Congress acts. Everyone is aware of the long-term financial shortfall facing the social security system, so our lawmakers decided to open the cookie jar and pass a 2% social security payroll tax cut for workers in 2011. This short sighted irresponsible action is a slap in the face to all future recipients which only exacerbates the financial imbalance in the system.

**<u>Schwab Form 1099</u>** – February 15th is the tax-mailing deadline for Schwab to issue your 1099 for taxable events in 2010. We have uploaded all your cost basis information to Schwab, so they will produce a separate gain/loss report with your cost basis and purchase dates for securities sold during 2010. Our management fees may be fully or partially tax deductible to you. The total may be found on your December Schwab statement. We encourage you to consult with your tax professional.

Warren, Lisa, and I send best wishes for good health and prosperity in 2011. Thank you for your continued trust and confidence. We are working hard to earn it.

January 12, 2011