Client Bulletin
April 2005

Investment Update – Following two years of solid gains, we've hit a bit of turbulence lately. After hitting 3 ½ year highs in early March, stock prices turned lower as oil prices soared to a record $58 per barrel and the Federal Reserve continued nudging up short-term rates with their seventh consecutive ¼% increase. There were few places to hide but thankfully we held a few. Over the last three months our average account dipped less than 1%. Foreign stock funds continued to lead the pack, outperforming U.S. stock funds. Over the last few years we have allocated 10-20% of most client accounts to international stock funds to diversify currency risk and take advantage of better valuations and growth opportunities overseas. In the U.S. there were pockets of strength in energy, natural resources, utilities, and media stocks. Financials, health care, technology, and real estate stocks were weak.

Fed Chairman Alan Greenspan's congressional testimony rattled the bond market and Treasury yields moved higher (bond prices lower) during the quarter. Selling pressure flowed through to most areas of the fixed-income marketplace. We booked profits and sold out of our emerging market and high yield bond funds as prices turned lower. Bond funds with a short-maturity bias held up fairly well while giving us 3-4% dividend yields. Preferred stocks and convertible-preferred stocks with yields in the 6-8% range were off slightly, which gave us an opportunity to pick up some additional shares for newer clients at reasonable prices. Tax-free municipal bonds, while subject to interest rate risk, continue to experience a steady demand from financial institutions and high bracket individual investors. For larger accounts, we employ a laddered maturity structure using different individual bonds maturing in different years. This assures that we'll have money coming due at different intervals that can be reinvested at prevailing rates.

We are holding higher than average cash balances as we continue to search for bargains, knowing that our principal is 100% secure and our yield is increasing. As the Fed has raised rates, money market yields have moved higher. We are earning over 2% at Schwab on cash, and that rate is headed up. Our goal has always been to achieve above average returns with below average risk. This entails taking some prudent risk with the proper diversification that's tailored to each client's stage in life and risk tolerance level. After the bear market experience that began in 2000, and continued through 2002, we take portfolio volatility very seriously. You can see from your color pie chart the number of asset classes employed for your portfolio to control risk. Please review this and let us know if you are uncomfortable with how you are currently positioned or if you would like to review your goals and asset allocation.

Energy & Natural Resources – This sector has been on fire as suppliers race to meet higher global demand as China and India continue to industrialize. Throw in political issues, potential terrorist strikes, volatile weather, and declining reserves and you can see why a Goldman Sachs energy analyst reported recently that oil could see a "super spike" to $105 per barrel. Could this really happen, or are the Saudi's sitting on excess capacity all the way to the bank? Given the large price moves of the 1st quarter, we could certainly see a pullback in the months ahead, but we do believe that this commodity bull market has legs and may likely continue for several more years.

Depending upon individual circumstances, each of our client accounts has varying degrees of exposure in this area. We own shares of the big global integrated producers like **ExxonMobil**, **ChevronTexaco**, and **BP Plc**. Chevron just announced a $16.4 billion (in stock and cash) acquisition of Unocal to bolster their development pipeline in Asia and the Gulf of Mexico. CEO David O'Reilly did a good job of integrating the Texaco merger, so pending regulatory and shareholder approval we expect more of the same with Unocal. Our top-performing energy stock in the first quarter was small cap independent **Encore Acquisition Co.** They're using horizontal drilling, water flooding, and high pressure air injection technologies to increase production in older U.S. fields. Their founder and CEO Jon Brumley, has a 30-year track record of success in the industry, with Encore being his sixth company. Another good stock for us has been **BHP Billiton Plc**, the world's largest diversified natural resources group, with operations primarily in the Southern Hemisphere.

For more diversified exposure, we own the **T. Rowe Price New Era Fund**, which holds 56% of the portfolio in energy stocks, with metals, forest products, chemical and steel companies prominently represented. The **Energy Select Sector SPDR** has raced ahead and continues to be a low cost alternative in the form of an exchange-traded fund. **Burlington Resources** is held in the **Oakmark Select** and **Oakmark Funds**. The **Dodge and Cox International Stock Fund** owns **Royal Dutch Petroleum** and **Total**, the largest oil company in France. The **First Eagle Overseas Fund** had invested years ago in hard asset commodity plays like **Rayonier** with timber holdings in New Zealand, and **EnCana Corp**., a Canadian energy producer. Throw in holdings **Nestle** in Switzerland and **Heineken** in the Netherlands and we're ready to party.

We also own income producing investments in the commodity / natural resource area like **Kinder Morgan Energy Partners LP**, with a 6.3% current yield. KMP owns a vast network of pipelines and terminals across the U.S. where they extract a daily toll and distribute a tax-advantaged dividend to investors. **Plum Creek Timber** is the second largest private timberland owner in the U.S. with 8.1 million acres in 21 states. They recently announced a deal to acquire 56,000 acres of timberland in Florida and have also been successful joint venturing with developers on some lake front parcels. We enjoy juicy dividends from two energy-related preferred stocks: **PreferredPlus El Paso Corp. 7.65%** and **Coastal Finance 8.375%** (which was acquired by El Paso in 2001). Both of these are now trading slightly below their $25 par value

Domestic Equities – Is there anything attractive to buy in the U.S. these days? Negative news announcements always create opportunities and the recent investigation of insurance giant American International Group (AIG) by New York attorney Elliot Spitzer is no exception. While we are not ready to buy AIG, General Re has been pulled into the fray based on some reinsurance agreements with AIG. General Re is one of the largest reinsurers in the world and is owned by **Berkshire Hathaway**. Berkshire is a holding company headquartered in Omaha, NE and chaired by Mr. Warren Buffet. He has assembled a terrific array of assets that currently includes $40 billion in cash, the most of any U.S. company. Berkshire's operating subsidiaries are engaged in a number of diverse business activities. The most important of these is the property and casualty insurance business. A few of their many operating subsidiaries include GEICO, See's Candies, International Dairy Queen, Fruit of the Loom, Shaw Industries, and Benjamin Moore. The company owns 12% of the outstanding common stock of **American Express**, in addition to large holdings of **Coca-Cola**, **Gillette**, and **Wells Fargo**. 2004 operating earnings for Berkshire exceeded $5 billion. The company shuns debt and states it's earnings conservatively. It takes no restructuring charges, issues no options and establishes ample insurance reserves. Mr. Buffet who turns 75 in August shows no signs of wanting to retire, and could run the company for at least another five years. He has stated that upon his death his job will probably be split, with one person overseeing the operating units and another responsible for the investment portfolio. We believe that Berkshire's intrinsic value significantly exceeds the current stock price and it is an excellent defensive holding. The "B" shares have an economic interest equal to 1/30th of each "A" share.

Healthcare and technology stocks have always been favorite areas for us. Although they have been weak recently, we continue to like the **Vanguard Health Care Fund** to capture the benefits from the aging of America. We're sticking with **Pfizer** believing they will overcome their current troubles with the FDA. **Johnson & Johnson** continued to move higher after announcing they will acquire medical device maker **Guidant**. After dropping 20% last year, we increased our position in tech titan **Cisco Systems** during the last quarter. Trading at the low end of its 52-week range, and expecting 15% revenue and earnings growth for 2005 from the corporate upgrade cycle, this networking leader appears ripe for a turnaround. The company has a 20% return on equity, no debt and $16.5 billion of cash and securities, worth $2.50/share.

Safe Money – As mentioned earlier, nothing beats cash for that nice secure feeling that the principal is locked in and will not go down. The **Schwab Advisor Cash Reserves** (the money market fund in your account) is sporting a current yield of 2.1%, up from under 1% last year. Bonds are safer than stocks since they are ranked higher on the corporate capital structure in the case of bankruptcy and they have a set maturity date. Super safe U.S. Treasury Bills maturing 9/29/05 now yield 3.1%, the 10-year Treasury note yields 4.5% and the 30-year bond 4.8%. U.S. Government Agency paper issued by the **Federal Home Loan Bank** and **Federal Home Loan Mortgage Corp**. trade at slightly higher yields, and like Treasuries, are exempt from CA state income tax. We have been nibbling on some corporate short-term notes issued by **General Motors Acceptance Corp. (GMAC)** due in late 2006 and early 2007. These are rated one rung above junk and have been hammered in price recently with the negative news out the parent General Motors Corp. We get paid semi-annually at an annual yield of 6.125% and these have been trading at a slight discount to par, meaning we can buy $10,000 maturity value for less than $10,000 today.

Other Fixed-Income – Short-term bond funds, like the **Metropolitan West Ultra Short** and **Strategic Income Funds** are yielding close to 4%, with low volatility to your share price. We're receiving a 6% yield paid monthly on a new purchase with the **Blackrock Global Floating Rate Income Fund**. Although the price has moved down, we expect the income dividend to grow as interest rates move higher. We added **Baxter International's 7%** convertible preferred stock to more client accounts, and also picked up more **Thornburg Mortgage** during the last three months. As a mortgage real estate investment trust (REIT), Thornburg is required to pay out 90% of its earnings, which gives us a sweet 9.5% yield.

We sold the **ProFunds Rising Rate Opportunity Fund** last quarter, and as luck would have it, shortly afterwards the Fed signaled a more restrictive stance and the producer price index came in stronger than expected. Given these new developments and the bond market's reaction, we reinstituted our hedge against higher rates by purchasing the **Rydex Juno Fund**. This fund is designed to short the 30-year U.S. Treasury bond, meaning that the share price will increase when long rates go higher, which is just the opposite of a typical bond fund. We'll watch it closely as the deflation/inflation battle continues to play out.

Lower Schwab Commissions – Minimizing costs for clients has always been important to us. Beginning May 25th, we will have an opportunity to take advantage of lower commissions on equity trades through Schwab Institutional. For household relationships under $1 million, we are currently subject to a $19.95 minimum on trades up to 1,000 shares. This rate will drop to a new $12.95 minimum, if the client consents to receiving trade confirmations and monthly statements via email. Unless we hear otherwise from you, we will release your email address to Schwab later this month so they may notify you with the details. They will then send you an email to which you must respond in order to implement this change.

Schwab Institutional is also offering a promotion from April 15 – August 15 that will reward existing clients with 30 free equity trades if they refer a new client who transfers assets worth at least $500,000 to Schwab.

Other News – More next time on inherited IRA's, college savings vehicles, privatizing social security, and how to deal with client incapacity. Thank you for your continued trust and confidence. We appreciate your business and look forward to working together in the years ahead.

Scott Walker

April 11, 2005