Client Bulletin
July 2005

<u>Portfolio Strategy</u> – After being humbled by the stock market decline of a few years ago, we now appreciate the comfort and virtues of holding a meaningful percentage of most client accounts in fixed-income securities. Using asset classes like preferred stocks, individual corporate bonds, closed-end bond funds, real estate investment trusts, and energy master limited partnerships we are receiving annual dividend yields in the 6-8% range with less volatility than common stocks. The majority of our clients are most concerned about protecting principal and generating a steady flow of interest and dividends, as opposed to maximizing capital appreciation.

"Sell to your sleeping point" was the advice of Benjamin Graham, the father of value investing when he was asked what percentage of a person's holdings should be in equities. We are sleeping well knowing that our clients have well diversified balanced portfolios with five to ten different asset classes to reduce risk. You can easily see the asset classes in your portfolio by reviewing the asset allocation color pie chart in your quarterly report package.

Generally, we advise no more than a 50% allocation to common stocks and stock funds when a client retires and stops earning income. Holding no-load stock funds, along with individual common stocks allows us to participate in economic growth and offset the eroding effect of inflation on future purchasing power. It also gives us the opportunity for a double-digit return on part of the portfolio. Knowing that market timing is a losing long-term strategy, having a well-designed asset allocation is the key to controlling risk. Holding no more than 10% of your money in one mutual fund and no more than 5% in an individual company security also reduces risk. Please call us if you would like to review your allocation in more detail so you can sleep well knowing your nest egg is positioned properly.

Following an April swoon, financial markets worldwide moved higher in May and June producing positive returns for the second quarter and year-to-date for the majority of our clients. Over the past year, our average net return after fees across all client accounts was 8.97%. It's been tough to generate any meaningful progress this year following the solid moves higher in 2003 and 2004. Valuations are reasonable and corporate balance sheets are strong, so if earnings growth exceeds expectations we could be pleasantly surprised with higher stock prices.

<u>Stock Funds</u> – Christine Benz, Editor of *Morningstar Mutual Funds* recently penned an article titled "The Only Mutual Funds You Need". We were happy to see **Oakmark**, **Oakmark Select**, and **Dodge and Cox International Stock** named as best-of-breed offerings under funds for longer-term goals. All three have been profitable holdings for our clients.

A sector fund favorite of ours, **Vanguard Health Care** closed to new investors recently. The fund had a $25,000 minimum investment and is now under a "hard close", meaning that existing shareholders are not allowed to purchase additional shares. **First Eagle Overseas** and **Matthews Asian Growth & Income** are also closed to new investors, but they are under a "soft close". This policy allows existing shareholders to purchase additional shares, and since we own those funds for existing clients at Schwab, we are able to buy shares for new clients under our master account relationship.

Fed Watch / Interest Rates / Bonds – The Fed has continued with their measured pace of rate increases (on June 30th, a ninth consecutive ¼% increase was announced bringing the short-term Fed funds rate to 3.25%). Long-term interest rates as measured by the 10-year U.S. Treasury bond have remained stubbornly low with that yield actually declining from 4.45% a year ago to just over 4% today. Serving out his final year as Chairman, Mr. Greenspan continues to orchestrate a tough balancing act to keep the economy growing while keeping inflation under control. Americans continue to spend more than we produce, with a wealth effect produced from years of rising real estate values and easy home equity money. On the other side of the world, we have many Asian nations, most notably China, producing more than they are spending. China and Asian central banks have chosen to recycle their U.S. dollar foreign exchange reserves back into U.S. Treasury bonds, keeping prices high and yields low. Seems that whatever China buys, the price goes up – like Treasuries and commodities; and whatever China sells, the price goes down – like many manufactured goods.

Given the low level of competing interest rates around the world, along with the deflationary effects on the global economy from China and India, we can begin to see why Bill Gross, the bond guru believes that 10-year U.S. Treasury rates will hover in the 3 – 4 ½ % range over the next 3-5 years. For new bond purchases, we have been employing a barbell approach with money divided between shorter-term (money markets & up to two year) maturities and intermediate term (7-10 year) maturities. This barbell gives us safety and potentially higher rates on the short end as the Fed continues to tighten, and deflation protection and higher coupons on the other end of the barbell.

Last quarter, we established new positions for many clients in short-term notes issued by **GMAC**, the finance arm of **General Motors**. Credit rating agencies downgraded GM and GMAC debt to junk status, creating the opportunity for us to buy. We've chosen shorter term paper issued by GMAC with maturities in late 2006 to 2009. These short-term notes have been trading below par, or maturity value, with yields to maturity of approximately 6.5%. GMAC debt generally yields slightly less than regular GM debt because the finance unit is profitable and because many investors believe that even if GM is forced into bankruptcy, GMAC would remain unscathed and pay off their bonds. GMAC earned $2.8 billion in 2004 and continues to post positive earnings.

International Affairs – Treasury Secretary John Snow has threatened trade sanctions against China if they fail to remove their currency peg to the U.S. dollar. By artificially pegging the yuan, also called the renminbi, to the dollar, China keeps the costs of its exports low, making it difficult for U.S. manufacturers to compete. By removing the peg, the yuan would most likely rise in value making American goods cheaper for Chinese buyers and help our balance of trade with Southeast Asia. Chinese controlled companies have tried to put some of their reserves to work with recent bids for **Maytag Corp.** and **Unocal**. Unocal has a merger agreement pending with **Chevron Corp.** and Maytag had a merger agreement in place with private equity firm Ripplewood partners. The Chinese bids are higher, so each company is obliged to evaluate them and proceed in the best interest of shareholders. If the Chinese controlled Haier Group is successful in buying Maytag, many of their 20 North American manufacturing facilities could face closure with those jobs moving overseas. Unless the unions wake up and re-negotiate health care and pension benefits, many U.S. industries will continue to operate at a severe competitive disadvantage.

<u>Preferred Stocks</u> – We've been nibbling at the Maytag Corp. 7.875% Public Income NotES [PINES] due 8/1/31, callable 8/8/06 at $25 par value (MPY). Our purchase price was below par value, producing a current yield over 8.00%. This is a trust preferred security that acts like a bond but trades on the NYSE and pays a quarterly dividend. The security carries a rating of BB+ by S&P. We believe the problems of higher steel, energy, and distribution costs will moderate and that the company will be successful in turning things around regardless of who ultimately gains control. Although earnings are down, the company still posted a profit of 0.10/share last quarter and has $99 million in cash. They also paid down long-term debt by $126MM last year.

Another new preferred for us is **Truststreet Properties** Series A 7.72% (TSY+A). Formerly U.S. Restaurant Properties, the renamed company was created following the February 2005 merger with 18 CNL Income Funds. Truststreet is the largest restaurant real estate investment trust (REIT) in the U.S. With $2.6 billion in assets, they manage financial interests in over 2,800 properties in 49 states. We purchased this preferred at a discount to its $25 par value giving us a current yield over 8%.

<u>Retirement Planning</u> – Individual Retirement Accounts (IRA's) hold billions in assets due to rollover deposits from company retirement plans. What happens to any remaining IRA balance when the owner dies? The entire account balance is not required to be paid out upon the death of the owner. The payout rules are different depending on whether the primary beneficiary is a spouse or non-spouse. A spouse has the flexibility to roll over the IRA balance into his or her own IRA. No further taxable distributions would be required if the spouse is under age 70 1/2. If the spouse is over age 70 ½, the money would be subject to the IRS required minimum distribution formula for the spouse. A non-spouse beneficiary is not eligible for a rollover, and is required to withdraw funds based on his/her life expectancy. This is why naming children and grandchildren as beneficiaries can "stretch out" and maximize income tax deferral. Any beneficiary may withdraw the entire balance without penalty when an IRA owner dies. This is typically not a wise move as all IRA distributions are taxed as ordinary income, and a large distribution could push the beneficiary into a higher income tax bracket. Great care must be taken when dealing with inherited IRA's to avoid triggering an unexpected tax liability.

<u>Real Estate</u> – Condoflip.com offers tips on the internet for buyers of preconstruction condos to resell or assign the property for a quick gain, and real estate investing seminars are being promoted with large ads in local papers. While a long-term case can always be made for owning real estate, those who have lived through past cycles know that prices can go down. Close to 50% of the real estate transactions in CA are now being financed with adjustable rate or interest only loans. That's fine as long as interest rates stay down or borrower's incomes rise in tandem with higher future payments, but what happens if rates continue rising and mortgage payments adjust higher than income grows? What happens when the leading edge of the baby boom generation considers retiring and most realize their investment income will not support their lifestyle? Their most valuable asset is likely their house, so they put it up for sale to downsize and invest the difference in income producing securities. Boomers have had fewer children than our parents, so that means fewer buyers, and builders continue to put up new homes. What happens to prices when sellers outnumber buyers? We've had numerous conversations with people lately about techniques to minimize capital gains taxes on the sale of rental real estate. Installment sales, 1031 exchanges, and creating a charitable remainder trust are viable alternatives to paying full capital gains tax in the year of sale.

We appreciate your business and look forward to working together in the years ahead. Please let us know if there is anything we can do to improve your experience with our firm.

Scott Walker

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