Review, Outlook and Opinion July, 2008

By: Scott Walker, CFP

We're experiencing the perfect storm in financial markets. The price of oil has skyrocketed to an all-time high of $144 / barrel, and the economy has slowed to a crawl as consumers tighten their belts. Housing shows no signs of bottoming, and stock markets around the world have turned lower. The Fed has brought short-term interest rates down to 2% last quarter in an effort to stimulate the economy. However, banks are keeping loan rates high to bolster their margins as they deal with a flood of non-performing loans and multiple low-ball offers on repossessed homes where the borrowers have sent in the keys. Higher energy and food costs have goosed the inflation numbers, which has pushed longer-term Treasury yields higher (10-year Treasury yield is 3.97%).

Is there any good news? Yes, energy and natural resource shares have been on fire. Bonds and bond funds have also held up well. As a safety valve, we have an above average cash position for many accounts which has helped to limit the damage. Our average client portfolio has dropped by less than ½ the overall stock market year-to-date, a hallmark of our asset allocation approach. We are not happy when account values dip, but we see no reason to sell good holdings when the fundamentals are intact, and the price has temporarily declined. However, when our original investment thesis has materially changed, or a holding is lagging their peer group, we will sell. We continue to recommend a balanced approach based on your personal risk tolerance and objectives. For all but the most conservative risk averse clients, this includes a meaningful equity component for growth and inflation protection.

It's important to maintain a sense of perspective during volatile market environments as it's tempting to jump ship and head for the life boats. But panicking and selling into the weakness can be hazardous to our long-term investment health. Your portfolio should be in line with your long-term goals, not short term market action.

Mistakes to Avoid – Here are some insights from a legendary mutual fund manager, Peter Lynch, the former manager of the Fidelity Magellan fund. He advises to avoid these four common investment mistakes:

1) Becoming too concerned about whether the stock market is going up or down. Instead of panicking during market declines, investors should expect periodic drops and make the most of them by accumulating shares that you think will perform well in the future.

2) Trying to time the market. Attempting to forecast whether the market is at a peak or in a valley and whether to buy or unload stocks as a result, is a waste of time. Drops are inevitable, but more importantly, over time the market will advance more that it will decline.

3) Not knowing the story behind the company or fund which you are buying. You should be able to explain in no more than three minutes and in simple language, why you like a particular holding.

4) Buying stocks for the short term. Over a period of one or two years, stock prices are totally random. Money that is needed in the near term has no business being invested in the stock market. Stocks are for long-term investors, who have the patience and discipline to hold for many years.

<u>Client Question:</u> What are some good safe alternatives for my money today? Treasury bills, or T-Bills are the risk-free benchmark of the world. A year ago these short-term securities were yielding close to 5%, but the recent flight to safety has brought down current yields to the 1.50% range, so after paying federal income tax and factoring in inflation, your real return is negative. Money market mutual funds are a little better and provide ready liquidity. The yields on bank CD's are low and the money is tied up with penalties for early withdrawal. The **Vanguard Short Term Investment Grade Bond** fund is a solid low cost option to pick up some extra yield. Good value exists in the municipal bond market where interest is exempt from federal income tax. California residents also enjoy no state income tax on interest from muni bonds issued by entities within the state. See "Bonds / Bond Funds" below for more details.

<u>Stock Funds</u> – We were early getting back into some financials like **Bank of America**, which was sold last quarter. At some point selling down energy holdings and buying back into financials will be a good trade, just not yet. We are sticking with best of breed companies and funds that have a competitive advantage and a global foot print in the market place. We expect large cap growth stocks which derive a significant portion of their revenue from overseas to outperform domestically oriented equities. The **Vanguard Primecap Core Fund**, **Janus Adviser Forty**, and **American Funds Fundamental Investors** are our stalwarts in this area. Add a top-performing mid-cap fund, **Fidelity Leveraged Company Stock**, with its large energy stake, and you own four winners.

Although currently out of favor, owning a small cap fund with a value tilt makes sense, since over longer time periods small cap stocks have posted superior returns. We sold **Wasatch Small Cap Value** and upgraded to the recently reopened **Third Avenue Small Cap Value** fund. Third Avenue has better performance and lower costs, and a penchant for buying stocks at a discount to intrinsic value. Almost 30% of its stocks are domiciled outside the U.S., with Sapporo and Fording Canadian Coal Trust among the top holdings.

We recently trimmed back our international stock fund exposure by selling half of the **Dodge and Cox International Stock** fund. The fund has produced large gains for us over the past few years and with over one-half invested in Western Europe, it was time to take some profits. Europe is struggling under the weight of higher interest rates, a super strong euro, and high wage & benefit costs. We continue to favor the emerging markets, specifically the BRIC countries of Brazil, Russia, India, and China. There are all kinds of risky alternative to play this developing country theme, but we prefer conservative exposure with the **Matthews Asian Growth & Income** fund and **American Funds New World**. They will overcome the current environment and thrive in the years ahead.

We continue to like and hold the **Wintergreen** fund and **First Eagle Overseas** for their value investing management philosophy and longer-term results.

<u>ETF Opportunity</u> – Health care has historically been a defensive area that performs well irrespective of the economic cycle. Traditional drug companies remain challenged, but we're looking to play this theme with the iShares Nasdaq Biotechnology (IBB) exchange-traded fund. As with all sector funds, it will be volatile, but the low costs, tax efficiency, and concentrated portfolio are attractive. Top holdings include Amgen, Celgene Corp., and Teva Pharmacutical Industries.

Common Stock Highlight – **F5 Networks** (FFIV) was a new acquisition last quarter, after we noticed institutional accumulation of their shares. This technology company specializes in application delivery networking for large corporate and government customers. Their products improve network performance and speed with a focus on security and optimization. The company has no long-term debt, and is reasonably valued for a growth stock. Microsoft, Oracle, and SAP all recommend F5 to their customers. Check out www.f5.com for more information.

Bonds / Bond Funds – Warren Isenberg and I traveled to Chicago at the end of June to attend the annual Morningstar investment conference. Upon returning, we decided to exit all leveraged closed-end income fund positions. These funds utilize short-term borrowing via the issuance of preferred shares to spike the yield on the common shares. While the above average dividends on the common have been nice, there is a problem brewing with the leveraged structure of these funds. The market for the preferred shares has locked up with no bids, so the cost of the leverage has increased. This will likely result in an upcoming dividend cut for the common shareholders, which will torpedo the share price. We chose to exit now with a small capital loss.

We have kept the **Nuveen CA Select Tax Free Portfolio**, (NXC). This non-leveraged closed-end fund has an average credit quality of AA, below average expenses of 0.37%, and a current tax-exempt distribution rate of 4.7% which is paid monthly. For clients outside of CA, the **Nuveen Select Tax-Free Income Portfolio**, (NXP) is a comparable alternative.

Bond funds give us a diversified group of bonds with monthly income. We believe in also holding individual bonds when pricing or yields are competitive. Last quarter we were able to participate in a new issue municipal bond offering by the City of Dana Point, CA Community Facilities District. These bonds were non-rated and non-insured so they came with higher than average yields. The bond proceeds will be used to fund infrastructure development (water, sewer, and streets) for the 30 lots that have been sold in the Headlands Reserve project. We will be repaid through a special mello-roos tax assessment levied on each homeowner's property tax bill. We are betting that the general economic downturn will not adversely affect the demographic segment that has purchased the last ocean front lots in Southern California, which sold for $4.5 to $7 million each.

High yield or junk bond funds own non-investment grade corporate paper and carry higher coupons than investment grade fare. These bonds were hammered in price earlier this year as the credit crises unfolded and fears of future defaults escalated. We noticed a turn up in prices in April, and took a position with the **Fidelity Advisor High Income Advantage I** (FAHCX) and **American Funds High Income Trust** (AHTFX). We may have been a bit early as prices have recently turned lower, so we are closely monitoring each fund and will not hesitate to exit if the situation deteriorates further.

These are tough times for all of us, but looking out over the next twelve months we believe stocks will likely outperform bonds and cash. We appreciate your continued trust and confidence. Please let us know if you have any questions or comments.

Scott Walker
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