Review, Outlook and Opinion July, 2009

By: Scott Walker, CFP

Time for a Breather – U.S. and international stocks shot higher last quarter as investors pounced on beaten down shares in anticipation of better times ahead. The areas that had been beaten down the most posted the best gains. Technology, financial, consumer-discretionary, and emerging market stocks were big winners. Energy, health care, and consumer staples lagged. We are likely to consolidate these gains over the next few months, until the markets get additional evidence of an improving economy and better news on corporate profits and future guidance. GM filed for chapter 11 bankruptcy last month, which is the second largest BK in history, after Worldcom in 2002. The only area to give up ground last quarter was U.S. Treasury bonds, where prices declined as long-term interest rates moved higher. Even though the Fed can keep short-term interest rates anchored near zero, they have no control over long-term rates which are influenced by inflation expectations. The 10-year Treasury has gone from near 2% at the end of last year to almost 4% in early June, and settled at 3.50% to end the quarter. Across all client accounts, we posted a net gain of 10.81% for the quarter, and 5.74% year-to-date. Your returns will vary based upon your asset allocation and individual holdings. Feel free to call and schedule an appointment to review strategy, allocation, and outlook with either Warren Isenberg or myself.

Ponzi Schemes – For your safety and our mutual convenience, we chose to set up your accounts at Charles Schwab & Co., as opposed to Walker Financial having custody of your funds. Many people have been duped and lost money because they did not adhere to this basic safeguard. They relied on fictitious marketing material that offered unrealistically high returns. Client account statements were then doctored up by the advisors to show fictitious gains. The perpetrators were able to pull it off by taking new investor money to pay off early investors, and it continued to work until the new money stopped coming in, and redemption requests escalated.

Convicted felon Bernard Madoff was sentenced to 150 years in prison after admitting in March to running one of the largest and longest financial frauds in history. Federal prosecutors have filed criminal charges against R. Allen Stanford, accusing the Texas financier of wire and mail fraud, and conspiracy to launder money in a $7 billion scheme that offered high interest certificates of deposit. Also, the Wall Street Journal reports that California financial adviser Danny Pang extracted at least $83 million in allegedly inflated fees, loans and salary from his Irvine based investment firm before it was seized in April by federal regulators who accused him of a massive international fraud. Mr. Pang's former company, Private Equity Management Group, also revised his estimate of potential losses by investors, saying they could range from $287 million to $654 million. The latter figure would represent a loss of nearly 80% of the $823 million still owed to investors. Avoid being taken, and always insist on having your funds held by a reputable independent third-party brokerage firm.

Low-Risk Investment Alternatives – The safest investment is to buy a direct obligation of the U.S. Treasury. You would buy a U.S. Treasury Bill (Tbill), with a three or six-month maturity. The flight to safety has pushed yields down to approximately 0.20%. FDIC bank insured deposits are safe up to the insured limits, if you can stand the low interest rates. After taxes and inflation, your real return is even lower. So, where can we pick up some yield without taking undue risk?

Bonds – We buy bonds for income and safety, 5% plus in most cases, and less risk than stocks. These are IOU's we receive when we lend out our money. The principal value of the bond will float and may go down prior to maturity, when our money is returned at par value, or a price of 100. Treasuries are the safest, then municipals, followed by corporate bonds. Interest rate risk with bonds is important. It becomes more of a factor as you extend maturity dates. Simply put, bond prices move inversely to interest rates. The highest quality bonds are the most sensitive to interest rate risk. For this reason, we are avoiding longer-term Treasuries, and have been buying short – intermediate maturity municipal and corporate bonds. Bonds may be issued at a premium or discount to 100, and always carry a coupon, or annual interest rate, paid semi-annually.

Bond funds which own a diversified mix of bonds never mature, but do pay out the interest earned in a convenient monthly dividend. We split our bond money between individual issues and funds for the best of both. We like funds with low costs and good performance relative to their peer group. Our lowest risk bond fund is the Vanguard Short-Term Investment Grade Bond Fund (VFSTX), 4% yield. Two of our favorite core bond funds with higher quality intermediate maturity holdings are the PIMCO Total Return Institutional (PTTRX) 5.9% yield, and Metropolitan West Total Return Bond (MWTRX) 6.3% yield. Yield represents the approximate annualized income after fund fees, on current principal value. Principal will fluctuate, so total return may be more or less than yield quoted. Bonds are usually up on days that stocks are down, so they help to reduce overall portfolio risk.

Municipal Bonds – Tax exempt interest makes municipal bonds attractive for higher bracket investors. They have been garnering a lot of attention lately with the gridlocked State of CA budget in Sacramento. The State has now issued IOU's, or warrants to pay in the future to certain vendors, instead of checks. At last count there was a $26 billion gap between projected revenues and expenditures for the fiscal year that began July 1. Hopefully, Governor Schwarzenegger and the hard working legislature will find a solution in the near future. State of CA general obligation bonds were recently downgraded by Fitch to BBB-. To reduce risk in this area, in early June we sold a CA 2024 bond and the Nuveen CA Select Tax Free (NXC) at good prices. We would not be opposed to repurchasing the CA bond at a lower price.
Despite the current uncertainty with the State, we expect demand for municipal bonds in general to remain strong as income tax rates are likely headed higher in future years. The Obama administration and Congress need to find a way to pay for the bailout measures, the health care proposal, and the ongoing entitlement programs. We save money for you by going direct and owning individual issues instead of using all funds. We continue to favor essential service bonds, like water and sewer related issues. For diversified exposure own the high

quality Vanguard CA Intermediate-Term Tax Exempt (VCAIX), tax-free yield 3.9%, and the American Century CA High Yield Municipal (BCHYX), tax-free yield 5.4%.

Build America Bonds (BABs) – The Obama administration has created BABs, a new type of municipal debt that's the financial crisis equivalent of war bonds. Interest rates on the taxable debt, created as part of the $787 billion stimulus package, are higher than typical tax-exempt municipals. Washington foots part of the bill with a subsidy to the issuers for 35% of the coupon payments, which makes them cheaper for municipalities. Local officials can use the proceeds to build bridges, fix roads, and spruce up schools, the sort of infrastructure projects President Obama is counting on the rev up the economy and job growth. The State of CA issued over $5 billion in late April, and the offering was oversubscribed. If the structure continues to be attractive, we will look to participate in any new offerings.

Higher Risk Bonds – As a tactical play, we will own lower-rated corporate bonds, referred to as high yield or junk bonds which are issued by newer less established companies and pay higher interest rates than their more seasoned peers. Prices are well off the highs and have turned up, so we have taken a small position here with the SPDR Barclays High Yield Bond (JNK) exchange-traded fund, yield 14%. The Loomis Sayles Bond Fund (LSBDX) also has approximately 1/3 in high yield paper, yield 6.4%. Global High Income (GHI) holds emerging markets bonds and has rebounded nicely after getting crushed last year, yield 9.5%.

Equities – The vast majority of stocks and equity funds built on their gains from March and continued moving higher last quarter. Expectations remain low, with estimates that S&P 500 operating profits will be down 35% in the second quarter. Third quarter estimates are not much better, but the fourth-quarter and 2010 estimates have shifted higher. A sustained advance in stock prices will depend on corporate earnings accelerating. There are some clouds on the horizon as unemployment has risen in recent months, while home prices continue to be weak and may drop further. The Labor Department recently reported that U.S. employers cut 467,000 jobs in June, and the unemployment rate ticked up to 9.5%, a 26-year high. This news knocked the stock market back on its heels, so we continue with the two steps up, one step back routine. There is $4.7 trillion of cash on the sidelines earning next to nothing, which represents fuel for a further stock advance. The economy is not suddenly going to shift into high gear and consumers are still struggling, so we are proceeding cautiously.

For a smoother ride with dividends, we like health care, consumer staples, energy, utilities, and big box retail. We have a position in financials and industrials as a turnaround play, and technology for risk tolerant accounts. We live in an interconnected global economy, so having international exposure to the emerging markets, particularly China, makes sense. We own and continue to like a lower-risk play focused in SE Asia, the Matthews Asian Growth & Income Fund (MACSX). This area has gone off like a rocket lately, so we're waiting for a pull back to increase our exposure for risk tolerant accounts with a low-cost exchange-traded fund, SPDR S&P China (GXC). We're also attracted to Brazil and their natural resource rich economy. The iShares MSCI Brazil (EWZ) is the best way to gain access.

Pending health care reform legislation has hindered this industry, but the leaders will survive and continue to grow. We have added to our position in XTO Energy (XTO) for their astute management and domestic natural gas assets. Prices are currently depressed, but any weather related event could quickly change the situation. Value conscious consumers will continue to gravitate to Costco (COST), and Pricesmart (PSMT), their Latin America counterpart. Utilities have been held back due to a cap and trade carbon emission bill that recently passed in the House of Representatives. FPL Group, Inc. (FPL) is ahead of the game and has started to add solar arrays to their natural gas plants to reduce carbon emissions. Consumer staple powerhouse Proctor & Gamble (PG) won't make us rich over night, but with a recent dividend increase last quarter and 3.4% dividend yield, slow and steady often wins the race. For insurance purposes, we're hanging onto gold (GLD).

Technology stocks and the NASDAQ are leaving the Dow and S&P 500 in the dust. We are a bit reluctant to chase hot areas, but on a price pullback we are looking to acquire more of a tech sector ETF, Vanguard Select Technology (VGT). Top holdings include the best of the old and new - Microsoft, IBM, Apple, Cisco, and Google. Search king Google has unveiled plans for a PC operating system (OS), Chrome, to compete with Microsoft. This is separate from Google's Android OS for mobile devices. The new OS is slated for a late 2010 release. For better growth potential, lower labor costs and a stronger balance sheet, we swapped Hewlett Packard for Infosys Technologies. INFY partners with all the big IT companies to bring an integrated platform solution to their Fortune 500 and governmental customers.

Last quarter we placed sell stop orders on several issues that had run up in price to protect our gains. When prices began to correct our shares were sold in iShares MSCI South Korea, Plum Creek Timber, Fluor, and Astec Industries.

Tax Planning – Keep in mind that there is a zero federal tax rate for 2008 – 2010 on long-term capital gains for taxpayers in the lower marginal tax brackets, up to 15%. Other higher bracket taxpayers still receive a favorable 15% rate on L/T gains. Assets must be held for over one year to qualify as long-term. The annual gift tax exclusion is $13,000 this year.

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

July 9, 2009