# Review, Outlook and Opinion ___________ October, 2007

**By: Scott Walker, CFP**

**Investment Overview** – Although we hit some turbulence this past summer, we're back in a confirmed rally mode for stocks and stock funds. Despite all the problems reported by the press, equities took off in mid-September following the Fed's move to reduce short-term rates by 0.50%, to 4.75%. This reversal in policy was huge, and that's a reason the Dow is now over 14,000. Given the strength in the September jobs report, Fed officials may pause at their next meeting on October 30, but odds favor another rate cut before year end as they attempt to reflate the economy and avoid a housing induced recession. Overseas equity markets have continued to do well for us and we see no reason for the trend to change anytime soon, but they will be volatile.

Here at home the residential real estate / sub-prime mortgage blow up has reverberated through the fixed-income market, with the higher yielding bonds and stocks taking a hit in price. The closed-end income funds and preferred stocks is where the weakness mainly occurred. Following the Fed cuts, prices have stabilized and in most cases moved higher, with our dividends continuing to be paid. We have selectively added to some beaten down securities.

Our average client account return for the quarter was 1.62%. Year-to-date we're up a more respectable 6.48%, and up 12.71%, net after fees for the past twelve months. You can find your returns on page 3, the Portfolio Performance Review. Please call with any questions.

**U.S. Stock Funds** – With recent moves we have tilted our stock exposure toward growth over value, and larger companies over small. Bill Nygren, the portfolio manager of the Oakmark Select and Oakmark funds did not respond to my recent email which questioned his rationale for continuing to hold Washington Mutual, the largest holding of Select, at 15% of assets. The fund made a lot of money for us during the bear market of 2000 – 2002, but has recently been disappointing, and it doesn't look like the lending business is going to come roaring back anytime soon for WaMu. We have been trimming back and selling shares of the Oakmark funds recently to upgrade into funds that are performing better in the current environment. With technology stocks springing back to life, we have participated with Vanguard Primecap Core, Fidelity Leveraged Company Stock, and a new position in the Columbia Marsico 21$^{st}$ Century Fund.

The Marsico fund favors sectors and stocks that are poised to benefit from macroeconomic trends. Management considers demographics, global competition, and industry consolidation. They insist on good company fundamentals like rising return on equity, free cash flow, financial transparency, and reasonable valuations. Top holdings include MasterCard Inc., Las Vegas Sands, Apple, Inc., and Google, Inc. Through a special Class "Z" share at Columbia, we were able to get a lower expense ratio versus going direct to Marsico.

We also initiated new positions last quarter in the American Funds – Fundamental Investors for large cap core exposure; and the Alpine Dynamic Dividend Fund, which employs a unique dividend capture strategy.

**Sector Funds** – These industry specific funds are more volatile than our core diversified equity funds, but offer the potential for higher returns through a focused portfolio. The majority of our sector funds are in the energy and health care areas, but we took advantage of the August sell off to add the Matthews Asian Technology Fund to many moderate risk and aggressive accounts. We get large cap, technology, and emerging market exposure all in one package. 80% of fund assets are invested in Japan, China/Hong Kong, Korea, and Taiwan. Top holdings include Samsung Electronics, China Mobile, Ltd., Nintendo Co., and Sony Corp.

Another sector fund we like is the PowerShares Water Resources Portfolio. This exchange-traded fund owns companies that comprise the Palidades Water Index. The fund owns companies that focus on the provision of potable water, the treatment of water, and the technology and services that are directly related to water consumption. Portfolio holdings include American States Water Co., ITT Corp., and Calgon Carbon Corp.

**International Stock Funds** – This has been our best performing asset class year-to-date and we remain optimistic about the prospects moving forward. Our largest holding, the Wintergreen Fund, has a global mandate with 70% of its current holdings domiciled overseas. The fund was up 9% last quarter, and is up 20% YTD. First Eagle Overseas is the Mr. Dependable of the group with the lowest risk scores. Dodge & Cox International is taking a breather, but continues to a favorite. We own two excellent global funds from The American Funds family out of L.A., The Capital World Growth & Income Fund & the New World Fund are marathon runners that have produced consistently superior results. Finally, Matthews Asian Growth & Income is a lower-risk way for us to play the China theme.

**Common Stocks** – Client holdings will vary based on your inception date, investor profile, and account size. Many of our stocks have rebounded to near 52-week highs. We favor globally exposed dividend paying companies from of a variety of industries. Stocks like General Electric, ConocoPhillips, Bank of America, Johnson & Johnson, Seaspan Corp., and Qualcomm. Berkshire Hathaway does not pay any dividend, but is a valuable holding company comprised of many fine operating businesses that are doing well.

Newmont Mining is a stock we picked up earlier in the year. It's the only gold mining stock in the S&P 500 and had a good quarter as money gravitated to gold bullion and gold stocks following the credit crunch. The stock has been a laggard, but a recent change in senior management along with a pipeline of new projects is positive. Gold stocks can be extremely volatile but serve a valid purpose as a hedge against general stock market risk. The weak dollar, fear of inflation, and uncertainty about the economy were the catalysts to push prices higher, and we believe gold has further upside.

For our more aggressive accounts, our newest idea is MEMC Electronic Materials (WFR), an industrial technology firm based in St. Peters, Missouri. They supply the semiconductor industry with silicon wafers, which are used to produce chips for computers and consumer electronics. The company is also involved in selling high-grade polysilicon to makers of solar cells, having recently begun supplying two Asian solar cell makers. Polysilicon is the raw material that helps convert sunlight into electricity, and as the demand for solar energy grows, WFR will benefit.

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**Preferred Stocks** – We were hurt last quarter in this area, but moving forward our dividends are secure and we believe prices will recover. We've started to accumulate shares in three investment grade issues where their prices dropped below $25 par value. Royal Bank of Scotland – 6.40% is traditional preferred stock, so it qualifies for the 15% maximum federal tax rate on qualified dividends. ING Groep N.V. - 7.20% is an exchange-traded debt security with no stated maturity date, so it also qualifies for the 15% tax rate. BAC Capital Trust – 7% is a trust preferred security that is guaranteed by Bank of America Corp. Trust preferreds are not eligible for the 15% tax rate since the parent company uses the interest paid to the trust as a tax deductible expense.

**Bonds** – High quality bonds, like treasuries and municipals rallied in the flight to safety. This pushed the yield down on the 10-year U.S. Treasury bond to 4.59% on 9/30, and near 4.00% on T-bills. These bonds provide a safe, secure element to our portfolios with a dependable income stream. Given the flatness of the yield curve, we have been targeting maturities in the short-intermediate range where we capture similar yields to long maturity bonds, but with much less price risk. For our more conservative accounts we just purchased a new issue federally taxable municipal bond. Issued by the State of California, these general obligation bonds are earmarked for stem cell research and cures. The bonds carry a coupon rate of 5.168% and are CA state income tax exempt. They have a mandatory put, or tender provision on 4/1/10, and are callable on 4/1/09. The bonds are investment grade and carry an A+ rating from S&P. With money market rates likely to fall, this locks in a safe yield for a small part of our fixed-income allocation.

**Closed-End Income Funds** – The price weakness of these funds has been disappointing, but we've been adding to Global High Income (GHI) with the knowledge that the UBS management team is solid and the bonds are a conservative way to play the emerging markets economies and get paid 9% annually, on a monthly basis. We continue to review, analyze, and monitor our PIMCO and Nuveen holdings in light of the current environment.

**Schwab Edelivery** – The majority of our clients have completed the on-line registration process for Edelivery of Schwab trade confirmations and monthly statements. This entitles clients to the lowest trading commissions from Schwab Institutional. If you have not yet completed the process, please take 5 minutes with your account number(s) in hand and go to www.schwaballiance.com and follow the prompts. Technical assistance is available from Schwab at 800-515-2157. If you're unsure of your account status or would like an update on your account(s), feel free to contact our office.

**Income Tax Savings** – The maximum elective salary deferral limit has been increased to $15,500 for 2007, for contributions to a 401(k), 457, or 403(b) plan. Those over age 50 are eligible for an additional $5,000 catch-up deposit. 457 plans also carry an alternative catch-up provision which may be used to defer more money during the last three years prior to the year in which you expect to retire. Contributions are pre-tax and account earnings compound tax-deferred. For those clients still working, we strongly encourage you to maximize your contributions to save on taxes and help assure financial independence.

**529 College Savings Plans** – Tax-free accumulation and withdrawals (federal tax only) for qualified education expenses have made 529 plans the first choice for college savings. These plans are regulated on a federal basis, but offered by individual states. You are allowed to have a plan offered by a state other than where you reside, and other than where the child attends college. Contribution limits are high, but there is a limited investment menu versus UTMA (Uniform Transfer to Minor) accounts, which was the preferred funding vehicle prior to 529 plans. The CA 529 plan was recently taken over by Fidelity Investments. Visit www.scholarshare.com for details. For new accounts, we currently prefer the State of Virginia plan where we can access a special share class of the American Funds with no up-front or back-end loads.

Warren Isenberg, CFP, Lisa Leahy, and I are at your service. We personally own many of the same securities found in our client accounts, so we’re invested along with you. We value your business and thank you for the continued trust and confidence.