Review, Outlook & Opinion October, 2010

By: Scott Walker, CFP

Market Analysis & Investments – Investor sentiment has significantly improved following the best September stock market performance since 1939. Stocks, bonds, and gold have been in rally mode which gives us pause when considering additional buys as many issues are extended in price at this time. We espouse a balanced conservative tax-sensitive approach for most clients, with 40% of aggregate client assets held in equities. For the past three months we posted an average net return of 6.4% across all client accounts. Stocks produced the best gains lead by technology, industrial, big-box retail, and the utility sectors. Financials, consumer staples, health care, and natural gas-focused energy stocks brought up the rear.

Inflation numbers are very low, and deflation fears are keeping the Federal Reserve in an accommodative mode providing monetary lubricant for a sticky economy. We don't want to end up like Japan which has been fighting a deflationary spiral for years with super-low interest rates following the 1989 bubble in their equity and real estate markets. It appears the Fed is pushing on a string, as lending activity at banks continue to languish. Cash yields remain near zero, and with the Fed targeting 0 – 0.25% short-term rates, it's hardly worth the trouble to tie up money in a bank CD when you can earn 3 – 5% by participating directly in the bond markets. Although no formal announcement has been made, Fed Chairman Bernanke has indicated a willingness to inject further liquidity into the system through the direct purchase of Treasury bonds. This news sent bond prices up to fresh highs. We'll likely have to wait until the next Fed meeting concludes on November 3, for an official news release.

Bond fund inflows continue at a brisk pace. This insatiable demand for safer income producing securities seemingly has no end. We have trimmed back and selectively sold into this rally to nail down gains on emerging market bonds, with Global High Income up 18% for the quarter. We also reduced exposure to some State of CA municipal bonds in favor of more localized general obligation or revenue bonds. We will be tuned in closely to the upcoming corporate earnings announcements and future guidance. Although October has a dark reputation for the stock market, the month has a positive record in years of midterm elections. Seven of the past nine Octobers in midterm years have been winner for stocks.

The incumbents are nervous given the fragile jobless recovery, so the pending shake up in Congress could be a positive catalyst driving stocks. Important income and estate tax laws have been left in limbo, so they go to the lame duck session next month. There's a reasonable chance that some of the Bush tax cuts which are scheduled to expire on 12/31/10 may be extended a year or two.

Equities – Please note that your holdings may not include all securities discussed due to different client start dates and price patterns. We believe in owning individual common stocks in growing companies diversified across different industries. We also own actively managed noload mutual funds for specialized managerial expertise in a given arena, like the **Matthews Asian Growth & Income Fund** for exposure to the most dynamic region in the world. **T. Rowe Price Health Sciences**, managed by physician Kris Jenner, allows us to profit from the aging of the baby boomers.

<u>Gold</u> – After an early July dip, gold rebounded higher posting its eighth straight quarterly gain. With the dollar being weak, the precious metal settled near an all-time record high of $1,300/oz., +5.2% for the 3-months. For many accounts we own the **SPDR Gold Trust (GLD)**, a sector exchange-traded fund that holds $56 billion in bullion housed in London vaults. The share price of this ETF is approximately 1/10th the value of an ounce of gold and closely tracks the price. In an uncertain world, gold has a certain allure for up to 5% of a portfolio, however we are reluctant to add exposure at these levels. Exchange-traded funds (ETF's) are good to own for their transparency, low costs, and tax efficiency. We sold our position in **Barrick Gold Corp.** last quarter to nail down a nice profit after the company reached our target price.

Dividends and high yielding securities are always tempting, but we have been burned in the past chasing yield, so we always think in terms of total return, and assess the upside potential and downside risk to the share price from our entry point. A nice current yield means very little if the share price is slipping.

<u>Energy</u> – Over the years we have noticed a tendency where holdings that were the largest decliners for a quarter, often rebounded to post good gains moving forward. **Ultra Petroleum Corp.** currently fits the bill. Their long-life reserves are located in Wyoming and the Marcellus shale in Pennsylvania. The company has a return on equity of over 30%, and the lowest cost structure in the industry. They will weather the current storm in natural gas prices. **Chevron Corp.** rebounded strongly last quarter, but **Exxon Mobil Corp.** may be the best buy now. The stock is trading 25% below its all-time high in December, 2007 and has languished this year following their large acquisition of XTO Energy, to expand natural gas reserves. Current year earnings estimates are $5.72/share, so at a price of $64.55, the shares trade at a relatively cheap price to earnings (P/E) ratio of 11.3. The company pays out only 31% of earnings for a 2.7% dividend yield, and has increased the dividend each year for the past 27 years.

<u>Utilities</u> – The Obama administration was successful in passing two landmark pieces of legislation this year regarding health care and financial regulatory reform. Legislation curbing emissions that cause global warming is stalled in Congress, which may be one reason that utility stocks rallied last quarter. Many big utilities also operate unregulated divisions that specialize in alternative energy like solar and wind power. They typically pay steady and growing dividends that become more valuable in a low interest rate environment. We own and continue to like **Nextera Energy Inc.**, and our local favorite **Sempra Energy** which owns San Diego Gas & Electric and Southern CA Gas Company. A more speculative turn around play is **NRG Energy**, a wholesale power producer that came public in 2004, and recently announced a partnership to build California's largest solar photovoltaic generating facility.

Technology – The prospects for the information technology industry continue to be favorable. Many companies are reluctant to hire new full-time employees; however, capital spending for technology projects continues to drive productivity gains. One of the biggest vendors with a global footprint in hardware, software and services is **IBM Corp.** They have $96 billion in revenue and 399,000 employees, and are leaders in innovation with over 4,900 patent awards in 2009. Even though the stock price is approaching an all-time record high, IBM expects to earn $11.29/share for 2010, giving them a very reasonable P/E of 12.

Google Inc. has a free voice command app for smart phones that provides tailored search results immediately. Smart phones powered by their free Android software have been selling well. "Google Apps" is slowly gaining traction but has formidable competition from Microsoft with Word and Excel. Cloud computing is here to stay as companies are reducing hardware, software, and storage costs by outsourcing and having their data housed offsite "in the cloud".

Fixed-Income Securities – Near record low interest rates (1-year Treasury bill 0.26% yield, 10-year Treasury Note 2.51% yield), and continued investor preference for lower-risk income producing securities have benefitted bond prices in a big way. Mortgage-backed securities represent the best value, so we have increased our position in the **Doubleline Total Return Bond Fund**. Lead portfolio manager, Jeffrey Gundlach and his team are specialists in mortgage-backed paper having honed their skill at TCW in Los Angeles. Gundlach is a past winner of Morningstar's Fixed-Income Manager of the year. He believes that mortgage interest rates are in a long-term bottoming process and that the 10-year Treasury (a key benchmark for mortgage pricing) will bottom out around 2% sometime later next year. The jobless recovery and weak housing market will keep the Fed pumping liquidity into the system. The fund's average price on its holdings is 97.94 versus the Barclay's Aggregate Bond Index at 108.30. The fund also sports an average duration of 2.69 years, versus the index at 4.12 years. The discounted prices, short duration, above average yield, and superior management are traits we admire with this holding.

We have also been buyers of individual new issue **Build America Bonds (BAB's)**. BAB's were legislated into existence during the first quarter of 2009 as part of the fiscal stimulus package designed to assist state and local municipalities and school districts. Issuers of BAB's are entitled to receive a 35% federal rebate for the interest cost on the bonds. This subsidy allows the issuer to offer a higher coupon to investors. These are federally taxable municipal bonds, and have seen strong demand from pension funds and other tax-deferred investment pools. At the beginning of the third quarter we were able to acquire new issue bonds at par value with 5% coupons maturing in 2017, but by the end of the quarter we had to extend to 2022 for high quality bonds to get the 5% yield to maturity. The BAB subsidy program is scheduled to expire on 12/31/2010, unless Congress decides to extend it.

Mortgage Refinance Opportunity – If you haven't checked mortgage rates lately, you are in for a pleasant surprise. For a conforming mortgage (up to $417,000), we are seeing 15-year fixed rates at 3.875%, with no points. Your interest rate will be higher with a 30-year note, but still in the 4.25% range. We typically recommend paying extra principal each month to shorten the remaining term, and reduce your interest costs over the life of the loan.

Tax-Free Retirement Income – A Roth IRA account with tax-free accumulation and distributions is an ideal retirement savings vehicle for young savers. These accounts are also appropriate for many older investors who have no need to tap IRA money for several years, and expect to be in a similar or higher tax bracket down the road.

Individual Retirement Accounts come in two varieties, traditional and Roth. Contributions to a traditional IRA are generally tax deductible, while contributions to Roth are not. High income earners are still precluded from contributing annually to a Roth, but the rules have changed for converting an existing traditional IRA to a Roth IRA. Income caps have been removed, giving everyone the option to convert their traditional IRA to a Roth. Benefits of a Roth IRA include:

- Tax-free income. Once you've had a Roth IRA for five years, all distributions from it are tax-free as long as you are at least 59 ½ years old. Regular distributions from a traditional IRA are taxable, and vulnerable to any increase in tax rates.
- No required minimum distributions (RMDs). Regardless of age, you won't have to withdraw anything from your Roth IRA if you don't need the money.
- For conversions made in 2010 only, the resulting taxable income can be divided equally between 2011 and 2012. Alternatively, you can choose to report the full amount in 2010, when tax rates may be lower.

All amounts converted are subject to ordinary income tax, and you will want to pay the tax from funds held outside of the IRA. If you think you might benefit from a partial or full Roth conversion, please contact us and we would be happy to coordinate with your tax advisor for a more thorough analysis.

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

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