WALKER FINANCIAL ADVISORS, INC.
Registered Investment Advisor

Investments & Wealth Management October 2013

Congress has been unable to come to an agreement on the budget; so many departments of the federal government have temporarily closed. While disturbing, this has occurred on 17 prior occasions and been resolved after brief delays each time. The impasse may continue until a last minute resolution around October 17th, which is the projected date that the $16.7 trillion debt ceiling will be reached. I believe cooler heads will prevail and a last minute compromise will be reached to avoid a U.S. default on our Treasury obligations. Warren and I would view any stock market sell off as a temporary decline in value and not a permanent impairment of capital. For those with a multi-year time horizon, stock valuations and dividend yields are still reasonable, so we would use weakness to accumulate shares at lower prices. Our strategy to deal with the dysfunctional politicians is to hold a diversified portfolio of high quality stocks, bonds, and funds, along with a comfortable cash cushion for bargain hunting and retirement income withdrawals.

Fed Tapering on Hold - Chairman Bernanke announced last month that the Fed would defer tapering their $85 billion per month of open market bond purchases and keep the monetary spigot open for now. President Obama has appointed Fed Vice Chairman Janet Yellen to replace Ben Bernanke in 2014. She and the other eleven members of the FOMC (Federal Open Market Committee) are responsible for setting monetary policy. They are sure to have a lively debate on when to begin tapering back the bond buying and remove the training wheels from the economy.

U.S. Stock Market – Strong corporate fundamentals have set the stage for what we expect to be favorable performance moving forward, although we are always cognizant of the downside risk. U.S. corporations have sturdy balance sheets with approximately $1.8 trillion in cash. Over the past year, companies have paid out $250 billion in dividends, and share buybacks have totaled $400 billion. Valuations are reasonable with the S&P 500 trading at 14.5 times 2014 earnings, versus a historical P/E of 16. The trailing earnings yield for the market (earnings/price) is 5.4% and compares favorably to bond yields. Key drivers for the economy and the market continue to be an improving housing market, rising domestic energy production, and a U.S. manufacturing renaissance powered by technology enhanced productivity.

Our best performers last quarter included chemical giant **DuPont**, with a significant overseas business benefitting as Europe begins to pick up steam. **Qualcomm**, the San Diego based wireless titan with no debt and a recently announced $5 billion stock buyback. A new position in a South Korea ETF acquired in August for more risk tolerant accounts also popped. Detractors included **J.W. Nordstrom**, **Realty Income**, **Intel**, **IBM**, and **Exxon Mobil**. It can be a mistake to blow out a stock based on one bad quarter, assuming the buy thesis remains intact, as a laggard can easily turn into a leader the next quarter.

U.S. Equity ETF – Stock dividends have always played an important role in our security selection process by providing tangible cash flow to boost total returns. WisdomTree was the first investment manager to weight ETF's by the dividend stream from stocks. This innovative approach led us to purchase the **WisdomTree Smallcap Dividend Fund** (Ticker: DES). Small company stocks have historically outperformed large cap stocks, and the dividends provide a source of income growth. This ETF has 25% in financials which stand to benefit from industry consolidation and an improving economy. Monthly distributions produce a current yield of 2.6%, and with share price appreciation we expect higher total returns.

International Stocks – Our preference is to hold a diversified basket of foreign securities via a mutual fund or ETF, as opposed to picking individual stocks from foreign countries. The **Matthews Asia Growth & Income Fund** has always served as the foundation of our international equity exposure. This fund has an excellent risk/return profile and has the flexibility to invest in any size company where the managers find the best growth at value prices in the region.

For more risk tolerant accounts, last quarter we purchased the **iShares MSCI South Korea** (Ticker: EWY) exchange-traded fund. The share price had been weak due to saber rattling with the North, unrest in Syria, and exports slowing in the region. South Korea has solid fundamentals and is cheap, trading at just 9 times forward earnings. Top holdings in the ETF are Samsung Electronics, Hyundai Motor Co., Kia Motors, and LG Electronics. These brands continue to gain market share, particularly in the U.S., and we expect continued growth moving forward. This holding gained 11.9% for us last quarter.

Bond Market / Interest Rates – Bond prices put in a short-term bottom and have been inching up since the Fed reversed course and put tapering on hold September 18th. The ten-year Treasury yield ended at 2.64%, up from 2.49% on June 30. Confidence has returned and bonds are finally having a bounce in price, with a safe haven bid boosting Treasuries, as the stock market pulls back. We are cautious, but gradually increasing exposure with ETF's or funds that are on the lower end of the risk scale, but still provide cash distributions in the 4% range. Municipal bond tax-exempt yields have increased to the point that we can get a 4% tax-exempt yield (Fed & State of CA) with the **American Century CA High Yield Municipal Fund**, so we reestablished a position in this no-load, no-transaction fee fund at a lower price point for our tax-sensitive accounts.

It is very slim pickings for buying individual bonds, since the yields are ridiculously low. We continue to hold many land-backed, or "Mello Roos" tax-exempt bonds which are typically non-rated and carry higher yields. These bonds are issued by Community Facilities Districts to fund infrastructure for new development, and repaid through a special tax that is collected on the property tax bill. The Village of Sendero in Rancho Mission Viejo is a local new issue we participated in this year.

Fixed-Income Exchange-Traded Funds (ETF's) – In the event the economy continues to gain strength and the Fed tapers its bond buying, it makes sense to hedge against higher interest rates down the road. We have purchased the **Powershares Senior Loan Portfolio** (Ticker: BKLN) to fill that niche. This ETF holds floating-rate bank loans that are privately arranged debt instruments typically issued in conjunction with leveraged buyouts, mergers, or acquisitions. The loans are senior in the capital structure of the issuer and secured by collateral. Interest rates on the loans are variable and typically reset quarterly. BKLN has a short duration, very low volatility, and a monthly dividend with a 4% current yield. Bill Gross, the skipper at PIMCO said last week he's emphasizing maturities in the 1 – 7 year duration range, so it's a good thing we already own the **Pimco 0-5 Year High Yield Corporate Bond ETF** (Ticker: HYS) which posted a gain last quarter, and sports a 4.4% current yield from the monthly payout.

Income Tax Planning – It's our standard procedure to review all taxable accounts prior to year end to check on net realized gains and see if there are any unrealized losses to harvest in order to offset the gains. Excess capital losses offset ordinary income up to a $3,000 annual maximum.

If you have any questions or comments regarding your portfolio, please let us know. Thank you for your trust and confidence. We work hard to earn it.

Scott Walker