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Quarterly Newsletter

First Quarter 2009

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Investment Summary- The first quarter of 2009 started with the continuation of the scary economic declines from the fourth quarter and ended with the hope that the worst was behind us. We now believe that the combination of worldwide economic/financial stability crises and the US stimulus/economic spending budgets/deficits are finally fully discounted in today's current financial asset values. However, reaching the bottom still means that we have a long way to go until the damage is repaired and markets go back up to historic valuation norms.

US Economy- The same 53 economists surveyed by The Wall Street Journal that missed forecasting the start of the recession, now predict it will end in September 2009. On the surface this lacks credibility, but forecasting the end is much easier than the beginning. In January and February the economic news was bad, yet decelerating. In March, the first "green shoots" of good news appeared: banks are making money, the market-to-market accounting rules are on the way out, the Fed announced a $300 billion long term treasury buy back, the Geithner plans were finally detailed and well received, and trade/inventory levels are bottoming out. Remember that the end of the recession (maybe this fall) means that the declines have stopped and the economy is again heading up from this depressed level. It will take years more to return to the economic health we enjoyed in the mid-2000s.

This first bit of good news, along with valuations being at 12 year lows, caused the world's best leading economic indicator, the US stock market, to find a bottom March 9th (Optivest clients with active stock portfolios received an email announcing this on March 10th) and to start a six week rally of over 28%. Besides being an economic indicator, the US stock market is an emotional indicator as well. Many people with steady jobs, whose retirement accounts had halved, stopped spending money even if retirement was still 20 years away. As the stock market recovers, so does the confidence of American consumers and business people.

Unfortunately, our current Administration's planned budget deficits, tax hikes and spending are now a bigger problem than the recession. Realization of this caused the value of all asset classes worldwide to fall sharply with every announcement in January and February as plan after plan was announced. While stimulus spending will help certain sectors like alternative energy, healthcare and education, it does little to the economy's real engine, free enterprise. The net result will be a slower than normal recovery from our recession, slower future growth, higher inflation and a weaker US Dollar. Please see our enclosed publication on "The New Normal" for an explanation of these effects.

Global Economy- Global economics, more than ever, are important to our U.S. economic recovery. We are in our fourth global recession since World War II, and the most severe and wide spread. According to the International Monetary Fund (IMF), only 17 of 182 economies tracked are expected to grow faster this year than last. 71, including 30 of the world's largest 34 economies, are shrinking. Interestingly, emerging market economies are expected to remain in positive territory, growing at 1.6% this year and 4% next. The U.S. led the decline and will lead the recovery. However, our exports and foreign sales (55% of the S&P 500) will be slow to grow as other nation's recoveries will lag.

Inflation- Inflation and its effect on all asset classes has always been one of the major factors in market price valuations. We believe that inflation peaked at artificial highs last summer (2008) due to speculation (think of oil at $150 per barrel) and reached an artificial low in early March caused by equally irrational fear. Prices of most commodities are still so low that they will have to rise just to meet demand for basic consumer subsistence. Once these wild price swings return to normal ratios with the economy, they will be subject not only to supply and demand issues but, also subject to changes in the value of the US Dollar compared to other currencies. The US Government's plan to sell $2.35 trillion of new debt this year (much more over the next 8 years) and its plan to expand the money supply to repay it, can leave little doubt to the upward bias of inflation in the years ahead.

Stock Markets- As we predicted in our stock market commentary on 12/10/2008, *Don't Waste a Good Recession*, the stock market appears to have bottomed by our March 2009 target date. Furthermore, as the S&P 500 is currently up significantly from its evil bottom value of 666, it is now officially in a new bull market (bull and bear markets are technically defined by 20%+ moves). In fact, it is the fastest advance to the 20% threshold since 1938. Even so, it is still 45% below its peak in 2007, and may take years to fully recover to new highs.

More important are the tactical shifts we made during March and continue to make for our investors. Stock market leadership is changing toward areas that benefit from a recovery and away from defensive sectors. Specifically, we have shifted our weightings to small and medium capitalizations from big, to value from growth, and to emerging countries from developed ones. In addition, and in keeping with our future inflation theme, we are buying Canadian Oil Trusts (14-20% dividends), commodity funds and Swiss Francs in smaller amounts.

Fixed Income- While fixed income investments declined in early March, they did not re-test their mid-December 2008 lows and have since moved into positive valuations for year-to-date 2009. However, like the stock market, corporate and municipal bond prices are still down considerably from their 2007 levels and represent unusually good values. Even the highest quality bond funds are yielding 5% and lesser grades are still paying 12-20%. Municipal bonds are yielding 4-8%, depending on maturity and quality. While valuations are cheap, inflation looms ahead, and we are attracted to medium term maturities that we can live with. In addition, we are adding inflation hedged income investments to add balance.

Real Estate- Commercial real estate continues to suffer from the lack of available financing. In a recent meeting with our banker, I was told that a majority of local and many national banks are not allowed to make new real estate loans until they reduce their existing exposure to REOs and non-performing loans. This has led to many current purchases that are being done for "all cash", hoping to be financed at a later time. Since the number of investors that buy without debt is small, transaction volume is down about 75%. This is a problem that may be with us for 9-18 more months.

Valuing our current real estate investment holdings in this environment is difficult. Clearly, even properties that have stabilized occupancy are worth less than last year, but may still be up from the level they were purchased. Many properties have had drops in occupancy and/or reductions in rental rates. Furthermore, a few properties have loan maturities pending in the next 18 months and are withholding or reducing cash distributions to prepare for negotiating with the banks. If the properties do not have to sell or refinance in this distressed lending environment, time is on their side and they can wait until the recession is long over and lending returns to a more rational state. Fortunately, there is neither an over supply of properties nor much new construction (unlike in the 90's). These factors will help the eventual recovery of occupancy and rents.

We do not receive current appraisals or other valuations from our various managing partners and have left the majority of our real estate values at cost (which is the general practice in our industry). However, when there is evidence of significant changes in circumstances, good or bad, we have attempted to make realistic price adjustments (see price valuation disclosures).

The current environment is providing some good buying opportunities where sellers must sell at discounted prices. While we believe that California commercial real estate is still over valued, there are a few parts of the country and product types that are favorable. We take a "top down" approach to real estate. Our first criterion is a geographic region of job growth. Rare as it might seem, there are areas of the Midwest and South that are adding jobs, particularly in the Obama spending arenas of energy, health care and education.

Our second criterion is product type. We are, for now, still avoiding general office, discretionary retail, industrial and R&D properties. We like apartments, self storage, basic necessity retail and medical office. Lastly, and importantly, we want to be in the "hot" growth areas of each local market (think of the Irvine Spectrum vs. Garden Grove). We want to be in the path of growth, where people are moving into and new retail is being developed.

On the residential side, there are some signs that selective local Orange County markets, and even some secondary markets, are starting to firm up, as prices rose 2.7% between February and March. Our sense is that by year end 2009, most properties will have found bottom. However, we have very low expectations of future price appreciation and predict only 2-4% price growth (like the '90s) for the next 3-5 years.

Forecast and Strategy- We are still cautious in our outlook, as more negative surprises are sure to come, yet optimistic that the next few quarters will be sideways as opposed to straight down. Many problems with the economy, financial institutions and our combined $52 trillion of consumer, corporate and government debt persist. Further, a realization that greed, leverage and fire in the belly capitalism are "out" and big government, taxes and huge national debts are "in", lead us to make the following forecasts.

1. Our current “great recession” will end by the fourth quarter 2009, with GDP growth in 2010 limited to a slow 2-3% vs. a normal 5-6% recovery.

2. The US stock market will end 2009 up 15% or better, but still take years to reach new highs again.

3. The bond markets will likewise rebound, yet spreads will stay wide by historic standards and yields will stay fairly high as re-inflation concerns grow.

4. Inflation favorable investments will out perform other asset classes for the next few years, as our economy recovers and our US Currency weakens.

5. Commercial real estate will continue to be vulnerable to financing problems into 2010 and will be a lagging beneficiary to our future economic recovery.

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