

April 9, 2009

Dear _____:

Despite the recent bounce in equity prices, the stock market remains at historic lows. The ten years ending February 2009 provided the worst ten-year return for the S&P 500 since 1900. Moreover, January and February proved to be the worst ever two-month start to a calendar year and by March 9th, the S&P 500 had reached a twelve-year low. Stocks have now logged negative returns in each of the last six quarters. It has been a devastating eighteen months for equity investors and we continue to share your frustration.

Here are returns for the five major asset classes:

Index	Asset Class	First Quarter 2009
Short/Intermediate-Term Bonds	Fixed Income	- 0.1%
S&P 500	Large U.S. Stock	-11.0%
Russell 2000	Small U.S. Stock	-15.0%
MSCI EAFE	Foreign Stock	-13.9%
Dow Jones Wilshire REIT	Real Estate	-33.9%

It is too early to say whether March 9th marked the bottom of the current bear market, but stocks have certainly rebounded in a dramatic fashion since. As we enter the second quarter, many economic issues remain unresolved and the financial crisis continues. However, a pattern is emerging of economic reports that are still terrible but do not appear to be getting worse. It is helpful to remember that the stock market typically begins to recover before the economy exits a recession. It is precisely when fear and pessimism are rampant that equity investors are presented with their greatest opportunities. There was widespread enthusiasm for equities in early 2000, when stocks were priced at 44 times earnings. In contrast, at today's price of just 14 times earnings, stocks are desired by few, despite arguably representing good value. In the words of legendary investor Sir John Templeton, "The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell."

With governments and central banks around the world throwing trillions of dollars at financial institutions and ailing industries, a heated debate has emerged as to whether deflation or inflation represents the greater threat to the global economy. Economists define inflation as an increase in the general level of prices of goods and services. Some experts are concerned about the advent of rapidly rising prices in the not-too-distant future. A consequence of rising prices is a decline over time in the "real" value of money, a loss of purchasing power where each dollar buys less than it used to. Economists generally agree that high inflation rates are caused by excessive growth in the money supply. So far, government expansion of the money supply has been offset by businesses and consumers hoarding bailout and stimulus dollars rather than spending them. At some point in the future, the inflation camp believes, business and consumer confidence will return, spending will pick up, and inflation will result. While many in this group agree that near-term stimulus is essential, they think that longer-term inflation is inevitable as governments will not be able to shut off the fiscal and monetary spigots quickly enough to keep price increases at bay.

Other economic experts believe that deflation represents an increasingly real threat to global economic growth, and that "trivial" concerns about long-term inflation should be put on the back burner in light of this potentially grave situation. Deflation is defined as a sustained decrease in the general level of prices of goods and services. It increases the real value of money as each dollar buys more than it used to and, therefore, is a disincentive to current spending. ("I'm not going to buy that house today; I know it will be cheaper six months from now.") Over the past six months, we have seen massive selling of assets to pay down debt (deleveraging) and an attendant collapse in consumption at both the business and consumer levels. This has led to a gap in aggregate demand worldwide. Some economists expect the contraction in demand to become a vicious cycle in which households and businesses continue, for many years, to choose debt repayment and saving over consumption. As demand collapses and remains weak, prices could enter a downward spiral. Central governments are the only ones with the ability to step in, fill the gap in aggregate demand, and, thereby, halt the deflationary trend.

While occurrences of deflation are extremely rare, they are much feared by economists and politicians because the deflationary mindset is notoriously difficult to reverse. The Great Depression offers a case in point. Despite the massive spending of FDR's New Deal, it was not until 1940, the eve of U.S. involvement in World War II, that gross domestic product (GDP) regained the level of 1929. Protracted deflation accompanied this tremendous decrease in demand. Five calendar years during the Great Depression (1930-1932, 1938, 1939) were marked by declining price levels. At least thus far in the current economic crisis, deflation has been avoided, although there has been a rapid decrease in the growth of the Consumer Price Index (CPI) from 4.1% in 2007 to 0.1% in 2008. The most recent reading was 0.2% for the twelve months ended February 28th. With overall inflation rates hovering close to zero in the major world economies and a few sectors such as residential real estate exhibiting actual year-over-year price declines, many wonder whether today's disinflation may yet turn into tomorrow's deflation.

There are very intelligent people with persuasive arguments on both sides of the inflation-versus-deflation debate. At Dowling & Yahnke, we follow these debates with great interest, but we do not place concentrated bets on which way the economic winds will blow. *Our goal as your adviser is to construct a risk-appropriate portfolio that will withstand any one of multiple economic scenarios that may unfold in the coming years. We believe that the best way to accomplish this task is through robust diversification, since different asset classes thrive in disparate economic and inflationary environments.* In an inflationary world, stocks typically outperform bonds, since companies can generally raise prices to customers to keep pace with rising input costs, such as labor and raw materials. In addition, Treasury Inflation-Protected Securities (TIPS) are designed to protect against rising prices. The principal value of these government bonds increases with the CPI, thereby ensuring a rate-of-return above the inflation rate. Finally, exposure to real estate, through either real property or real estate securities, is a good inflation hedge, since landlords have the ability to raise rents.

Conversely, in a deflationary environment, bonds, other than TIPS, would be expected to outperform stocks. In a broader sense, it is better to be a lender than a borrower in a deflationary environment, as the inflation-adjusted value of debt obligations increases over time with declining prices. Those with large mortgages may want to bear this in mind. One way to hedge deflation risk would be to aggressively reduce mortgage debt, perhaps by refinancing a 30-year loan into a 15-year loan at today's low fixed rates. Our objective is to help you structure your overall financial situation in a manner that enables you to withstand whatever comes your way.

You may notice, that beginning this quarter, we are showing Real Estate Securities as a separate category in our portfolio appraisal reports, and in the performance table on the first page. These modifications do not represent a change in investment strategy. We are simply reflecting the fact that Real Estate Securities have different performance characteristics than other equities. Their performance is more closely aligned with real property, which makes them an effective inflation hedge, as well as a good portfolio diversification tool.

Thank you for your continued trust and confidence, not to mention your frequent words of support and empathy, over the last eighteen months. It has indeed been a trying period, but we will get through this together. As always, do not hesitate to contact us with your questions and concerns.

Sincerely,

DOWLING & YAHNKE, LLC