

July 10, 2009

Dear Client:

While clouds remain on the horizon, we are cautiously optimistic that the worst of the financial and economic tempest is behind us. Despite a continuing rise in unemployment, the economy shows some signs of stabilization and even incipient growth. Consumer confidence readings have improved over the last couple of months and are back to their pre-September levels; credit, while still tight, has become a bit easier to obtain; durable goods orders rose in May for the third time in four months; and new home prices increased in May.

Stock markets in the U.S. and around the world have rebounded sharply since their recent lows on March 9th. In the three and a half months leading up to June 30th, the S&P 500 index returned 36.9%, the Russell 2000 index 51.7%, and the MSCI EAFE index 47.5%. Notwithstanding, all of these indices remain far below their peak levels reached in late 2007.

Here are the second quarter and year-to-date returns for the five major asset classes:

Index	Asset Class	Second Quarter 2009	Year-to-Date 2009
Short/Intermediate-Term Bonds	Fixed Income	1.7%	1.6%
S&P 500	Large U.S. Stock	15.9%	3.2%
Russell 2000	Small U.S. Stock	20.7%	2.6%
MSCI EAFE	Foreign Stock	25.4%	8.0%
Dow Jones Wilshire REIT	Real Estate	31.5%	-13.1%

With regard to the financial system, we are encouraged that most banks passed the U.S. government stress tests, and those that did not pass have been able to raise needed capital from the private sector. In addition, a number of banks have begun repaying taxpayer funds borrowed under the Troubled Asset Relief Program (TARP). To date, some \$68 billion has been repaid. At its June meeting, the Federal Open Market Committee (FOMC) reported that, while the U.S. economy is “likely to remain weak for a time...the pace of economic contraction is slowing.”

Many challenges remain before the U.S. and world economies return to anything near full capacity utilization. Consumer spending, which accounts for nearly 70% of U.S. gross domestic product, has contracted sharply in reaction to the destruction of wealth in the stock market and the housing sector, coupled with job losses or fear thereof. Approximately 20% of residential mortgages are “upside down” (loans exceed the value of the property), and a similar percentage of commercial mortgages are likely in the same situation. Initial claims for unemployment benefits rose in mid-June after declining during the previous four weeks, and employment reports showed an unexpectedly high number of jobs lost in June.

The problems being experienced by the national economy are even more acute in California. The state faces a growing budget deficit as tax revenues plummet due to the recession and the steep drop in property values. California’s deficit for the 2010 fiscal year is now projected at \$26.3 billion. In addition, due to the uneven timing of state revenue collections, California faces a cash crunch in late July. These factors recently led a major credit rating agency to downgrade California’s general obligation debt to BBB, the lowest rating of any state and the same rating California had from July 2003 through May 2004. Not surprisingly, investors are questioning the safety of California municipal bonds.

The cash crunch is largely a timing issue. Significant portions of California’s tax revenues are collected only at certain times of the year (e.g. property taxes); however, the government has to pay its bills each and every month. Hence, the state needs to borrow money to supplement its cash flows in the dry revenue months. This is normal practice. If California’s elected officials are unable to reach a budget compromise soon, the necessary short-term borrowing will not be in place when the state needs the cash in late July. Moreover, given that California has not had a budget surplus since fiscal 2006, investors are likely to demand higher interest rates in exchange for providing capital to the state. One potential risk to current owners of California municipal bonds is that new debt may be issued at higher interest rates and that outstanding California debt may decline in price as a result. Investors who hold their bonds to maturity should still expect to be paid the full face value of the bonds at maturity and receive regular coupon payments along the way. In the interim, however, the prices at which the bonds are valued may be lower than the current prices. The risk is, therefore, one of lower valuations, not loss of principal.

Our confidence in the safety of California general obligation (GO) bonds rests on the state constitution. California GO bonds are secured by the full-faith-and-credit of the state, including full taxing authority. Under the state constitution, GO debt service comes before all other expenditures, except state-funded education. Despite its troubles, California is collecting more than enough cash to cover the constitutional mandates for education and debt service. In the first ten months of the current fiscal year, the state took in almost \$70 billion in revenues. About half of that was spent on education, leaving roughly \$35 billion to cover debt service, as well as other spending needs. Debt

service in that time period amounted to approximately \$3.5 billion, so clearly California had ample cash to make the necessary payments. Even in a cash crunch, general obligation bondholders would be paid while state contractors and employees would receive IOUs. In summary, while the California budget situation is bound to result in drastic spending cuts, and likely increased taxes and fees, we still believe that existing municipal bond holders will experience the timely payment of interest and principal owed to them.

On a happier note, we are delighted to announce that Racquel Kolsrud has joined Dowling & Yahnke as a Portfolio Manager. Racquel has ten years experience in the financial services industry, most recently as a Financial Consultant at Charles Schwab & Co., Inc. (Schwab). She holds the Certified Financial Planner (CFP®) designation, and while at Schwab, oversaw client assets in excess of \$400 million. Racquel has made her home in San Diego for the past six years. In her spare time, she enjoys competing in triathlons.

Finally, as required each year, we are providing you with our Privacy Statement. We wish you a relaxing and enjoyable summer. We appreciate the trust and confidence you have placed in us and invite you to contact us if you would like to review your portfolio or discuss your situation in greater detail.

Sincerely,

DOWLING & YAHNKE, LLC