



October 9, 2009

Dear Client:

Stock markets around the world continued their sharp rebound in the third quarter. The major stock indices recorded their best quarter since 1998 with the S&P 500 climbing 16%, the Russell 2000 rising 19%, and the MSCI EAFE up 20%. While these indices have staged a dramatic recovery since March 9, 2009, they remain well below the peak levels reached in October 2007.

Here are the recent returns for the five major asset classes:

Index	Asset Class	Third Quarter 2009	Year-to-Date 2009
Short/Intermediate-Term Bonds	Fixed Income	3.3%	4.9%
S&P 500	Large U.S. Stock	15.6%	19.3%
Russell 2000	Small U.S. Stock	19.3%	22.4%
MSCI EAFE	Foreign Stock	19.5%	29.0%
Dow Jones REIT	Real Estate Securities	35.4%	17.7%

It has been just over a year since the collapse of Lehman Brothers plunged the global financial system into its worst crisis since the 1930s. When we wrote our third quarter letter a year ago, the bear market had yet to exact its maximum toll; investors had not yet experienced the scary declines that characterized the stock market from late 2008 into early March 2009. Neither we, nor anyone else, knew when the turn would come; however, we remained cautiously optimistic, based on the historical evidence that a turn would indeed materialize at some point. In that letter, we included a chart, updated on the following page that showed the market reaction to three previous crises in our nation's recent financial history, as well as the

subsequent recovery. We concluded that the current financial crisis would pass and that equity investors would ultimately be rewarded. Nonetheless, the faith of even the most disciplined long-term investors was tested in the dark days of early 2009.

Event	Reaction Dates	No. of Months	S&P 500 Return	Recovery Dates	No. of Months	S&P 500 Return
Arab Oil Embargo/ Nixon Resignation	Jan. 1973 to Sept. 1974	21	-43%	Oct. 1974 to Dec. 1976	27	86%
Early 1980s Recession	Dec. 1980 to July 1982	20	-17%	Aug. 1982 to Aug. 1987	61	282%
Technology Bubble Burst	Sept. 2000 to Oct. 2002	26	-47%	Nov. 2002 to Oct. 2007	60	95%
Global Financial Crisis	Oct. 2007 to March 2009	17	-55%	March 2009 to ???	???	52% to 9/30/09

So what have we learned? The bear market and recent rally have reinforced some key lessons in investing. First, appropriate asset allocation is of paramount importance. For investors who rely on their portfolios to cover living expenses, high quality, short-term bonds provide a safe pool of funds essential to riding out tough markets. The security of knowing one's bills can be paid from a secure pool of assets eases the fear associated with declining account balances that can lead to rash decisions. Another lesson is that alternative investments do not necessarily zig when the stock market zags. For many years, hedge funds and funds-of-hedge funds have been sold to investors as investment vehicles that would provide downside protection in bear markets. As sophisticated institutional investors such as Harvard University and Yale University can attest, most alternative investments were pummeled, just like stocks, in this bear market. Harvard and Yale have reported that the returns on their endowments were negative 27% and 25%, respectively, in the fiscal year ended June 30th. Both endowments de-emphasize traditional stocks and bonds in favor of alternative investments. Combined, the two endowments reported investment losses of nearly \$17 billion in the latest fiscal year!

What lies ahead? Most economic experts agree that the extraordinary measures taken by the U.S. and foreign governments and central banks in the wake of Lehman's failure have successfully averted a depression. As we enter the fourth quarter, signs of a nascent economic recovery continue to multiply. In mid-September, the Chairman of the Federal Reserve, Ben Bernanke, declared that the recession was most likely over. His view is supported by the leading economic indicators, which have been in positive territory for the last four months.

Credit markets, following near seizure, are back to pre-Lehman conditions. U.S. export growth has rebounded sharply and many foreign economies, led by China, are experiencing a V-shaped recovery. Corporate profits climbed nearly 30% year-over-year in the first half of 2009, a record for any recession. The U.S. unemployment rate remains troublingly high at 10%, but the historical data suggests that unemployment does not normally peak until approximately six to twelve months after an economic recovery has begun. Those that would predicate their investment strategy on unemployment levels are effectively driving while looking in the rearview mirror.

This is not to say that our worries are over. There are still many negatives on the horizon that could derail or dampen any economic recovery. These include high debt levels in both the private and public sectors, a financial sector that is out of the ICU but still in the hospital, a weak commercial real estate market with impending mortgage reset/foreclosure issues, enormous budget deficits at every level of government, the danger of a nuclear Iran and North Korea, and the threat of both deflation and inflation depending on how these factors play out. In light of these risks, we have been rebalancing accounts as portfolio equity weightings have risen above target due to the recent market rally. Historically, sharp recoveries have followed sharp recessions, and there is evidence that the cash that fled the equity markets over the last two years is slowly starting to find its way back into stocks. Despite a slight dip since March 2009, cash on the sidelines in money market funds and short-term deposit accounts remains at unusually high levels. This is one reason we are optimistic about the long-term direction of the stock market; however, we know that it will likely follow a meandering path rather than go straight up. As always, we counsel patience and a focus on the long term in ensuring a successful investment experience.

As the end of the year approaches, we would like to take this opportunity to remind you of a few tax-related items. As many of you know, required minimum distributions (RMDs) from IRA accounts have been waived for 2009. For those who would still like to take an IRA distribution this year, please let us know as soon as possible. If you would like to make charitable stock gifts this year, please notify us as soon as you can, but ideally no later than the first week of December. Many of you have authorized us to report directly to your tax professional. If we are not currently serving you in this way and you would like us to, please provide us with the name and contact information (including e-mail address) of your tax preparer by the end of the year.

Finally, we are pleased to announce that, for the third year in a row, Dowling & Yahnke was the only San Diego firm with an adviser on the *Barron's* Top 100 Independent Financial Advisers list. This recognition is a reflection of the trust you have placed in our firm over the years. We are grateful for your confidence in us throughout a very difficult time and look forward to continuing to work with you for many years to come.

Sincerely,

DOWLING & YAHNKE, LLC