

While we welcome the generally improving economic data, we are mindful that the nascent recovery still faces many risks, including a still difficult credit market. While interest rates are near historic lows, many consumers and small businesses continue to have trouble obtaining credit, which is likely to be a drag on GDP growth. We expect economic news over the next few months to be a mix of pluses and minuses as a slow expansion continues.

Putting Portfolio Diversification to the Test

Precipitated by the worst credit crisis and biggest threat to the U.S. financial system since the 1930s, the recent bear market has led some investors to question the value of portfolio diversification. The sell-off across multiple asset classes from October 2007 through early March 2009 resulted from the perfect storm of economic conditions:

- Years of lax lending standards and excessive leverage combined to create a massive housing bubble.
- When the bubble was finally pricked by the inevitable slowdown in home price appreciation, the ripple effects were exaggerated by high levels of securitization and the creation of complex derivative products held on the books of nearly every major financial institution around the world.
- As the magnitude of the problems became evident, most assets, with the exception of U.S. government bonds, were trampled by a stampede to quality and an unprecedented demand for liquidity.

While portfolio diversification can reduce risk, it cannot eliminate risk. Diversification helps protect portfolios against *unsystematic* risks, or those specific to a particular company, industry, or country. Diversification does not protect against *systematic* risks, such as war, political upheaval, or similar events that impact financial markets in general. Portfolio diversification remains a valuable tool for investors because:

- Diversification did reduce investor losses in 2008 and early 2009. Investors who owned balanced portfolios of stocks and bonds, though they lost money, still fared better than those solely invested in stocks.
- The value of diversification cannot be judged over a mere 18-month period. This type of rush to judgment was made by those who abandoned diversification during the late 1990s, loaded up on technology stocks, and were severely burned in the subsequent dot-com market crash.

- While portfolio diversification is not a magic bullet, it remains an essentially zero-cost way to manage total portfolio risk. It is our belief that the secret to long-term investment success is to build broadly diversified portfolios in the most cost effective and tax efficient manner, taking into account each investor's willingness to accept risk and need for liquidity.

After the Holidays Comes Tax Season

Income tax season is approaching once again. In mid-February, clients with taxable accounts should be on the lookout for:

- Form 1099-Composite from your account custodians (1099-Composite combines information on interest income, dividend income, mutual fund distributions, and security sales).
- Realized Gains and Losses Report, prepared by Dowling & Yahnke, reconciles the security sales in your taxable accounts with those shown on Form 1099-B and provides the purchase dates and cost basis information needed to complete your tax returns. Please save the Realized Gains and Losses Report and include it with the other information you provide to your tax professional.

Enhanced Reports from Dowling & Yahnke

In our ongoing efforts to provide you with concise and meaningful reports, we are pleased to introduce our new Dowling & Yahnke quarterly report. The new report includes color charts, a portfolio summary, and re-designed pages, which we hope will make it more informative and easier to understand. It is the result of many months of hard work by our operations team, as well as some technology investments we have made to better serve you. We welcome your feedback and are happy to answer any questions you may have regarding the change in format.

Coincidentally, Charles Schwab & Co., Inc. (Schwab) is also unveiling a new format for their account statements this month. The main difference is that the new statements are laid out in portrait rather than landscape style. Please contact us with any questions about the new Schwab statement as well.

Expanding Our Leadership Team

Finally, we are delighted to announce a new addition to our staff. Mark Muñoz joined Dowling & Yahnke in October as Chief Operating Officer. Mark will oversee the firm's administration, financial management, investment operations, and compliance requirements.

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In addition to an MBA from the University of Chicago, Mark has extensive and diverse experience in operations leadership, including ten years managing capital markets businesses for Bankers Trust, Lehman Brothers, and Bank of America in the U.S. and overseas. Prior to joining Dowling & Yahnke, he was co-founder, Chief Operating Officer, and Chief Financial Officer of two industry-leading wireless technology companies. Mark was born and raised in Ohio and moved to La Jolla in 1999 where he currently resides with his wife and two children. Mark is a member of the University of Chicago Alumni Club of San Diego and volunteers for various charitable and educational causes.

We thank you for the opportunity to help you navigate the financial shoals over the past year and look forward to working with you in 2010. Please do not hesitate to contact us should you have any questions about your portfolio.

Sincerely,

DOWLING & YAHNKE, LLC