



Q1 2011 Quarterly Investment Commentary

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California has put its drought at least temporarily behind it with the massive amount of snow that has fallen this year. While a warm summer will likely remind everyone how dry it can be, for the moment there is plenty of water. The investment markets have had a good run in the last several months as well, and with the economy showing solid signs of improvement, we can feel our recessionary drought is history. Yet while it rains yet again in Northern California today, those watching the economy were reminded of a potential future dry spell by Standard & Poors putting U.S. Treasury debt on negative credit watch. Their concern over our deficits and accumulated debt are now coming into public acknowledgement, hopefully triggering an eventual rain dance from our politicians in the form of an agreement on how to reduce our future deficit issues.

Summary

Market returns for the first quarter of 2011 were strong. All major asset classes were positive, with commodities (energy, in particular), U.S. equities, and publicly traded real estate (REITs) leading the way. Developed and emerging international equity markets were also up nicely, but lagged their U.S. counterparts. The S&P 500 Index has experienced a strong 26% rise since August 26th and a 105% rise since the March 2009 low. Small and mid cap stocks have risen even more.

Our portfolios remain strategically positioned for slow growth in the U.S. economy and a rising, though volatile, stock market. Earlier in the year we increased our large company U.S. stock allocation to profit from an undervalued U.S. market, but remain slightly conservative to our blended indexes. We slightly reduced our allocation to emerging markets when we increased our U.S. stock allocation, but still believe strongly in the fiscal health and economic potential of these fast growing countries.

Volatility has been on the rise and, with history as our guide, we will not be surprised to see it continue. Investment markets can and will be highly unpredictable in the short-term. But over longer periods of time, fundamental values and positive performance generally prevail. We position our portfolios accordingly. Thoughtful investors who think in terms of decades, as opposed to days or weeks or even individual years, tend to do well.

Going forward, it is important to recognize that structural and geopolitical challenges make this an unusual recovery. Uncertainty over the price of oil, which is 50% higher than it was a year ago, presents a broad range of risks to the current expansion. Should prices continue to rise, they will have a noticeable drag on the recovery, reducing business investment and discretionary consumer spending. We are watching for this possibility closely. If oil prices moderate and the economy continues growing solidly, the Federal Reserve will likely begin to raise interest rates, possibly before year end. In recent history, the Fed has telegraphed policy changes of this nature in the language used in their meeting minutes.

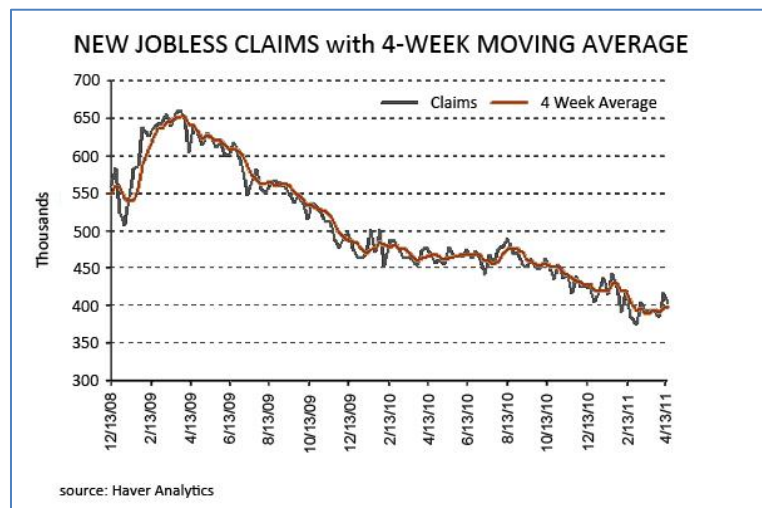
First Quarter 2011 Market Performance

Asset Class	Index	Q1 2011
Commodities GSCI	S&P GSCI Index	11.57%
Small Cap U.S.	Russell 2000	7.93%
Mid Cap U.S.	Russell Midcap	7.63%
REIT	Wilshire REIT Index	6.72%
Large US Value	Russell 1000 Value	6.46%
Large US Growth	Russell 1000 Growth	6.02%
U.S. Stock Market	S & P 500	5.92%
Commodities	Dow Jones Commodity Index	4.44%
Developed International	MSCI EAFE Equity Index	3.44%
Emerging Markets	MSCI Emerging Markets	2.10%
Arbitrage	HFRI Merger Arbitrage Index	1.57%
Fixed Income- Foreign	BarCap Global Aggregate	1.06%
Fixed Income - US	BarCap Aggregate	0.43%
Cash	30-Day Money Market Yield	0.03%

Q1 returns in the US were strong in all asset classes, with the S&P returning 5.9%, outpacing Developed International at 3.4% and Emerging Markets at 2.1%. All U.S. equity classes exceeded the S&P, with Small Cap leading at 7.9%, followed by MidCap at 7.6%, Large Value at 6.5% and Large Growth at 6%. Commodities rose, with the Dow Jones Commodity Index positive by 4.4% and the more energy laden S&P GSCI rising 11.6%. Fixed Income returns were positive with the US BarCap Aggregate up by .43% and the Global Aggregate at 1.1%.

Continued Economic Growth

Large parts of the U.S. economy continue to show signs of strength; manufacturing leads the way. Regional surveys have posted robust readings, with the Philly Fed Survey rising to its highest level since January 1984 and the Empire Manufacturing Survey moved to a very strong 17.50 reading. The ISM Manufacturing Index, which is a national measure of manufacturing health, confirms an expansion is well under way, even though the rate of growth will slow in the coming six months.



The Index of Leading Economic Indicators posted its eighth-consecutive monthly gain. While the number of unemployed Americans has been uncomfortably high for far too long, the labor market continues to improve and we believe is picking up speed. The four-week moving average of jobless claims, a leading indicator for labor, has moved below the critical 400,000 level, while many business surveys are now indicating a greater willingness to hire. The March labor report showed the unemployment rate decreased to 8.8%, the lowest level since March 2009, while the economy added 216,000 jobs. These data point to a continuing expansion of the U.S. economy.

Emerging Economies

The health of emerging economies is critical to worldwide economic growth. Their rapid consumer growth and quickly expanding middle class provide abundant new opportunities for U.S. and other developed market economies. U.S. exports are currently beating economists' estimates and more cargo is heading toward Asia from Long Beach than is coming in, a sharp reversal from several years ago and a major contributor to the U.S. economic recovery. By 2032, the combined gross domestic product of the seven biggest developing economies will likely exceed that of the G-7 (the world's largest industrialized markets) and China could overtake the U.S. as the world's largest economy.¹ We believe this is an inevitable trend, and our above average allocation to emerging market economies will benefit from this growth. As shown in the chart below, the growth in emerging economies is significantly benefiting their stock markets over the last 5 years. The additional volatility inherent in emerging market stocks is offset within our portfolio construction by slightly larger allocations to conservative investments. Emerging stock market growth certainly will not be linear; it will be accompanied by occasional fears of inflation, monetary slowdowns, and other growing pains. However, we are clear that the trend is positive for these economies and are allocating client capital accordingly

5 Years Through March 31, 2011	Avg Annual Performance	Growth of \$10,000*
Vanguard Emerging Markets Stock Index Fund	10.0%	\$16,200
Vanguard Small Cap Index Fund	4.8%	12,600
Vanguard Mid Cap Index Fund	4.4%	12,400
Vanguard 500 Index Fund	2.5%	11,300
Vanguard Developed Markets Index Fund	1.4%	10,700

*Investor shares, rounded

Inflation and Interest Rates

While there have been many media reports (even Federal Reserve members) suggesting that inflation will be an issue, a combination of factors lead us to believe that inflation is likely to stay contained. 13 Fed officials have spoken publicly in the past two weeks in 23 public speeches all over the world. Several officials, including Minneapolis Fed President Narayana Kocherlakota, have given individual interviews to news organizations expressing a concern over inflation. However, other Fed officials (William Dudley and Sandra Pianalto) are taking the more "dovish" stance expressed by Federal Reserve Chair Ben Bernanke.

¹ Price WaterhouseCoopers, January 2011 report.

The smartest economic minds in the country cannot agree on the future path that inflation will follow. Since we are in the business of evaluating outcomes, we lean towards the belief that core inflation will stay mitigated so long as oil prices do not trend terribly higher. Inflation is a function of the supply of money and the speed with which that money circulates. The supply has increased by a staggering amount and we are seeing prices creep up for basic input goods (food price inflation was one cause of the Tunisian and Egyptian revolutions). However, the impact has been and should continue to be moderated by the twin realities that banks remain hesitant to lend and people/institutions remain hesitant to over-borrow. So, despite the increases in commodity prices (including energy), we do not think embedded core inflation will become a major issue in the near term.

The question of rising interest rates is an entirely different issue, and a growing economy will eventually push the Fed to raise rates. While low rates stimulate the economy, they also are the source of potential financial bubbles and inflation, and make it much more difficult for retirees and those on a fixed income to make ends meet. When the Fed discontinues the \$600 billion of Treasuries it is purchasing in June (“QE2”), rates will likely rise. If the impact is greater than 1.5%, we would need to reevaluate our assessment of U.S. growth.

A second cause of potentially higher market interest rates will be U.S. deficit spending and increasing debt. As we have written in previous letters, current spending levels are unsustainable. We are pleased that our elected officials have finally seemed to get the message and are working to address overspending; the difficult political negotiations are getting a push from the recent credit quality questions raised by Standard & Poors. The specifics of spending reduction are always difficult, but we no longer have an alternative. “Austerity” in government will be needed, and this will slow economic growth somewhat. However, this “medicine” is much better than having the financial markets eventually decide to extract much higher rates as they have done with Greece, Ireland, and Portugal. Should the markets assess that serious progress has been made on the deficit, we think the net result will be more confidence in business owners and an increase in general economic activity. If the political will to restrain spending does not come to fruition, our longer-term view of inflation will change.

Housing

The timing of a housing recovery remains uncertain. In February, existing home sales dropped 9.6% and national home prices have fallen to their lowest level since April of 2002. Additionally, building permits fell to their lowest level in over 40 years, while new home sales fell 16.9% to a record low. Housing, which was once over 6% of GDP is now approximately 2%. While this means that further deterioration won't affect GDP significantly, a slow housing recovery delays an increase in the wealth effect, thereby keeping consumer spending growing very slowly.





The Economy and Markets Going Forward

Interest rates will probably rise as the economy continues to grow and as the Fed raises rates sometime late this year or early in 2012. To mitigate the rise in rates, last fall we began diversifying into shorter duration fixed income and into the alternative investment asset class. These “alternatives” should provide a stable return with low volatility and should be an excellent alternative to a portion of the fixed income.

U.S. economic growth should continue and businesses will add workers, although more slowly than any of us would like. Significant progress on reducing the deficit and lowering the cost of government has already started and should continue, thereby encouraging economic growth. We expect emerging markets to continue to grow more quickly than our domestic or other developed international markets, and anticipate your portfolios will benefit from this trend.

Improvements to Opes Financial Planning

We continue to add innovation to the annual planning process. We frequently see clients who have sufficient net worth to retire comfortably, but who have this wealth in illiquid assets such as real estate and business partnerships. Opes’ new “Balance Sheet Architecting” module will examine your current and expected future liquidity situation so that we can design the most effective strategy to produce the liquid assets you will need for your retirement cash flow. Carlos Valdivia’s real estate expertise and Adam Gensler’s tax and planning expertise are available to add value and insight into your situation. We are the only firm we know of that brings expertise in stocks and fixed income together with real estate and real estate finance to truly provide our clients the most effective planning solutions.

Best regards,

Mark, Dave and Adam

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