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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

A little more than a year ago, the stock market plumbed the depths of despair. **Since March 9, 2009, stocks have rallied dramatically. The broad market, measured by the S&P 500, has appreciated 72.85%, in one of the strongest bull market rallies of the last century.** In hindsight, the financial markets, a year ago, had over reacted to the undeniably serious economic situation we were in. Markets are not supposed to over react, but they do. In the past year, the market has recovered as dramatically as it declined, but not without considerable concern along the way.

As is typical in these situations, the market rallied long before there was any evidence of economic recovery. Even now, we have just about reached that phase in the economic cycle where the metrics are beginning to stop getting worse. **Soon there will be evidence of a sustainable recovery, the stock market will have regained equilibrium and begin to discount the new economic cycle**, and our success will be determined by correctly identifying the factors which will characterize this new cycle.

Massive government stimulus programs have been approved, but most of the funds remain to be spent. This, in combination with the very low interest rate environment maintained by the Federal Reserve Bank, leads us to believe the government is determined to support a continued economic recovery. **How, and when, the regulators determine that economic growth is self sustaining creates a risk. If they stop too soon, the economy could wither before growth becomes sustainable. If they wait too long, the economy will become overheated and inflation will threaten to erode prosperity**. At this point in time, we think both extremes are unlikely, but we would attach a somewhat higher probability to regulators keeping stimulus in place for too long.

Our forecast, however, is for the economy to grow at a somewhat slower pace than we have become accustomed to in the past couple of decades. We also believe that this slower growth will be accompanied by somewhat higher inflation than we have seen over the past twenty years.

Since the late '80s, our sense of prosperity has been driven by the wealth effect of the rising value of our homes. Related to this has been the easy credit available, either unsecured via credit cards or through equity lines of credit and refinancing of our homes. **During the early '80s, the ratio of consumer debt to disposable income was about 65%. Since then, the ratio has doubled and now stands at about 130%. In other words, the consumer will be severely constrained in the coming years.** Much has been said about the role of the consumer in driving economic growth. Indeed, consumption or personal spending is said to be the engine that drives the US economy, accounting for 70% of GDP. As a consequence, we tend to underweight sectors dependent on consumer spending in the US market, even though we are favorably disposed toward consumer stocks in emerging markets.

For most of this decade, the US dollar has been under pressure, with the trade weighted dollar only showing strength as a safe haven currency during periods of global financial stress. **This dollar weakness has been a blessing to US manufacturers. Companies which compete on a global basis have enjoyed a pricing advantage which will allow them to maintain an advantage, even if the dollar simply stabilizes at these levels**. Also, since much of the fiscal stimulus, on a global basis, involves the building and maintenance of infrastructure, we are positive on the long term prospects of producer manufacturing and capital equipment stocks.

In summary, we see 2010 as a year of transition from rapid economic recovery to a sustainable economic cycle characterized by slower growth and, eventually, higher inflation. The markets have been favoring the stocks of those companies which can thrive in this environment. We expect this trend to continue.

Fixed Income Market

Funds continued to flow into bond funds this past quarter. According to the Federal Reserve flow of funds data, US households followed the theme of safety as they continued to shift money into bond mutual funds. **This has kept corporate bond yields in a relatively tight spread range, as companies refinancing debt continued to be met with strong demand**.

As we wrapped up the 4th quarter earnings releases, corporate results have been positive. **Of those in the S&P500, who have reported, the average earnings growth rate was above 16%, excluding the finance sector. Additionally, non-financial companies have reported a net increase in top line sales for the first time since 2nd quarter 2008, with an average sales growth of 3.5%.** The financial sector figures have been even more impressive as bank loan problems have declined and balance sheets have improved. This data points to continued strength in companies and in turn their debt prospects. Given this improving macro environment, we continue to seek yield opportunities in short-intermediate high quality corporate debt.

On the municipal front, California recently offered a $2.5 billion sale of general obligation bonds. The demand for the bonds was very high causing the offering to be increased in quantity from $2B to $2.5B and yield dropping to 5.65% on the 30-year maturities from a pre-release estimate near 6%. This offering was increased in spite of California having one of the lowest credit ratings among the 50 states. **Tax free California muni's are still popular because of the increasing federal tax environment and low probability of default on the general obligation bonds of a state which is equivalent to the 8th largest economy in the world.** It is good to remember that not all municipal offerings will avoid default and it continues to be important to evaluate the risk/reward tradeoff for any specific offering you are considering.

In international bond news, we have seen the difficulties faced by Greece and the recent downgrade of Portugal. These troubles in the European Union have led to increased pressure on sovereign debt, in general. Yet, it seems likely that France and Germany are nearing agreement on the International Monetary Fund's involvement in an aid package for Greece to allay some of the fears related to a Greek default. **Additionally these European concerns have not adversely affected the domestic bond market, as few US companies have large exposures to Greece or Portugal.** We continue to maintain an eye toward safety and reasonable yield when evaluating all bond purchases for your portfolio.

International Market

Europe has dominated the international headlines for the past few months as the "PIIGS" melodrama has played out. Portugal, Italy, Ireland, Greece and Spain make up the PIIGS nations; they all share the common characteristics of having uncompetitive economies, carrying high debt, and running huge budget deficits. Hence, they are either in or near some type of sovereign debt crisis. **The worry is, if these crises are not handled properly, trouble will spread to other EU nations and potentially drag the world's most powerful trade bloc into economic turmoil.**

To understand the issue, one has to determine what has brought these countries to the brink of ruin. While many reasons are cited, the use of the Euro as a common currency played a large part. **There is a fundamental and structural dynamic to resolve, when using a single monetary policy to serve a group of member nations, each with its own set of fiscal policies.** Simply, some countries are more disciplined in managing their budgets, some are not. All else being equal, countries that are more disciplined tend to compete more effectively than those that aren't. Uncompetitive countries have the option of devaluing their currency in order to bring the prices for their goods in line with international competitors. However, since Greece is tied to the Euro, it is limited in its ability to achieve the necessary deflation to become competitive. Without the ability to control monetary policy they are limited to such draconian measures as wage cuts, and the reduction or elimination of all but the most essential government services and fiscal expenditures. Otherwise, their economies are doomed to further deterioration. **Although the situation has stabilized as the stronger EU nations have agreed to provide support during the current crisis, there is still no clear long-term solution to the fundamental problem.**

Besides Europe, China also finds itself in the headlines over the trial of four Rio Tinto Group executives and the announced withdrawal of Google from China. **How these events play out could have a broader implication as the world seeks to understand the trend of China's policy and whether China will be more, or less, open for foreign companies.** In addition, U.S. lawmakers are voicing their disappointment over China's currency policy, as the threat of the U.S. labeling China a "currency manipulator" increases.

In spite of these concerns, economic activity is gradually returning to normal in much of the world. As economies regain their growth momentum, Central Banks are starting to withdraw excess liquidity. The concern, as it is with the U.S. policy, is that stimulus is removed in a careful and orderly fashion. So far, we see the trend as a long-term positive and believe the global economy will continue to recover. However, we do see capital markets as riskier than they were last year, when they could only recover. Now, with stock prices higher, exposures need to be monitored more closely. **Geographically, we continue to underweight Europe; we are still positive on Latin America and Asia, but we are watching China carefully. In general, we still find the valuations attractive in the emerging markets**.