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## A New Year: A New Beginning

This is the first Commentary published by our new firm and we are proud to use it to display the very broad array and depth of talent and insight that the merger of Kochis Fitz and Quintile Wealth Management has assembled. We've brought these two firms together for several key purposes: to preserve our independence for the indefinite future, to provide greater career opportunities for our people, but chiefly, to enhance the scope and quality of our services to our clients. We hope this Commentary provides a preview of many good things to come.

Some of the thoughts that follow will seem more familiar than others. As the integration of our firms' service offering proceeds over the coming months, we're confident that you will appreciate, even enjoy, some new perspectives and fresh insights.

While overall investment performance for client portfolios for the full year of 2007 was respectable, the final quarter of 2007 continued the tone of uncomfortable market volatility. Markets were up strongly in October, very weak in November, and up and down in December as the year drew to a close. Still, 2007 performance for client portfolios was in line with long range expectations for their asset allocations and demonstrated again the wisdom of broad diversification. Happily, no clients suffered any significant exposure to the direct losses incurred in the big investment story of the year. The worldwide credit crisis, spawned by the domestic sub-prime mortgage debacle, took its toll, indirectly, of course, by deeply unsettling equity and bond markets. Rich Palmer provides considerable insight on this in one of the articles below.

We always decline to offer any short-term predictions, and with the still unfolding credit situation, weak residential real estate statistics, continuing geopolitical turmoil, near record high oil prices, and an election year coinciding, it might be especially foolish to do so now for the coming year. Market performance in the first week of 2008 is not offering any especially happy news. Still, we are confident that the durable investment strategies we've helped our clients develop, combined with our continuing search for better, cheaper, and more tax efficient means of implementing those strategies, will continue to serve our clients very well in 2008, and beyond.

With our sincere best wishes for a happy and successful new year...and our genuine commitment to do all we can to make it so.

Tim Kochis, San Francisco  
Rob Francais, Los Angeles

## Credit Market Cycles and Investment Implications

"Doubt is not a pleasant condition, but certainty is absurd."

Voltaire

### Uncertainty amidst a Credit Crisis

The "R" word is now being mentioned for 2008. Luminaries, such as Alan Greenspan, are now more emphatic that a recession is more likely to occur due to the credit markets' seizure. The credit crisis has thus far cost Bear Stearns, Citicorp, and Merrill Lynch their CEO's, forced multiple financial institutions to seek capital contributions, and contributed to the decline in US home prices. We'll attempt to explain briefly what's going on here and draw lessons for clients on how to react within a strategic investment framework.

Figure 1

#### Tale of Two Bubbles

	Stocks 2000-02	Houses 2007
Peak value, in trillions	\$13.1	\$21
Peak value, % of GDP	136%	153%
Drop from peak, in trillions	\$6.7	\$2-6**
Drop from peak, % of GDP	75%	30-57%*
Leverage†	2%	48%

\* Assumes 10-30% drop in home values, 2007 to 2009, 5.5% nominal GDP growth

† Margin debt as a percentage of stock value, mortgage debt as a percentage of home values

Sources: Federal Reserve, Commerce Department, NYSE, WSJ research

The *direct* effects of the housing bubble do not necessarily imply a US recession in 2008. Residential construction activity has decreased US real GDP by 1% over the last several quarters. Recent decreases in home values have reduced consumers' ability to finance consumption. Still, consumption rose at an annualized 3% rate for the 3<sup>rd</sup> quarter. While we are concerned that mortgage defaults

will rise from resetting adjustable rate mortgages (ARM's), we note that the potential impact upon consumption from households likely to be affected by future foreclosures is estimated to be only 0.3% of real GDP.<sup>1</sup>

<sup>1</sup> Estimates assume that consumption for such households drops by a substantial percentage (i.e., 20%).

Despite that, we are concerned about the credit crisis fall-out, the lack of asset pricing transparency and absence of timely valuation disclosures. High inter-bank lending rates demonstrate that banks are reluctant to lend money to each other. Credit spreads, measuring the compensation required for accepting credit risk, have risen substantially and could climb further in 2008. While monetary authorities worldwide may work to provide liquidity, banks with impaired capital levels and uncertain outlooks may nevertheless remain reluctant to extend credit.

### What's an Investor to do with Uncertainty All Around?

We answer that question, in part, by framing portfolio management within a long-term *strategic* context: asset allocations and investment strategies are selected with expected after-tax returns and volatilities to be realized over long horizons. We do not pursue momentum investing, tactical allocation shifts, or, especially, product strategies having poor disclosures and opaque price discovery.

The current environment reinforces our confidence in our core investment philosophies and of the subsidiary managers we employ for our clients. It also reminds us of the wisdom of a skeptical stance. We insist that our subsidiary managers:

- Understand return implications from using leverage.
- Use leverage prudently and only within established long-term strategic limits.
- Carefully control, and if warranted, avoid allocations to securities having inefficient price discovery.
- Maintain skepticism of high credit ratings for structured products.
- Recognize that some money market and "low" duration debt funds may have substantial credit exposures, resulting possibly in significant and surprising price volatilities.<sup>2</sup>
- Seek diversification in credit-sensitive sectors, targeting mostly the higher credit grades within a sector.
- Diversify asset class holdings across broad geographies.

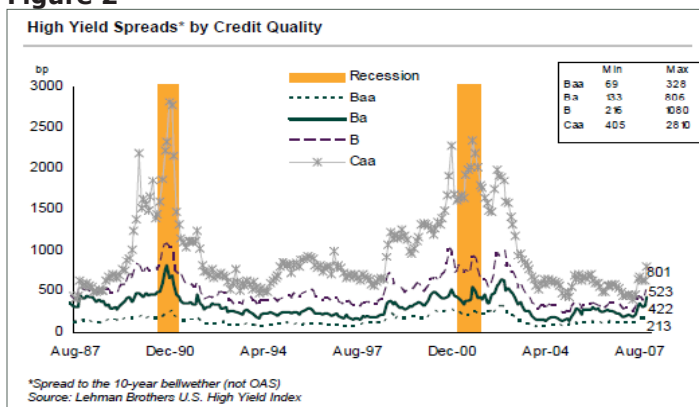
<sup>2</sup> "Money market" funds may hold structured vehicle debt, like packaged pieces of sub-prime loans. Such fund families include Barclays Global Investors, UBS, Charles Schwab, Deutsche Bank, BNY Hamilton Funds and Morgan Stanley.

**Credit Cycle Behavior: Present and Prior Profiles**

Credit cycles vary in length and severity and reflect the proverbial “greed” and “fear”, characteristics that describe the extremes in investor risk preferences. As with many forms of human behavior, history repeats itself in the capital markets. During a crisis, investors quickly abandon specific markets but then subsequently return.

Most credit crises manifest themselves in credit premiums<sup>3</sup> increasing substantially and in a volatile manner. From May 2007 through November 2007, the yield spread of the Lehman US Corporate High Yield (HY) Index rose from 2.38% to 5.56%. Figure 2 below traces the spreads of different HY credit grades over the last 20 years. Credit premium levels last peaked during the 2001 US recession and did not decline meaningfully until 2003 when US economic growth had resumed.

**Figure 2**



A byproduct of a credit crisis is the scramble for high quality, liquid debt. This strong preference for low-risk assets results in yields on such paper falling dramatically relative to other debt. From May 2007 through November 2007, intermediate yield spreads over similar maturity Treasuries rose by 45 to 50 bps for composite US AAA debt and by 80 to 90 bps for composite US AA debt.<sup>4</sup> This crowding into liquid, shorter-term paper is evidenced by 2-year Treasury yields dropping to 3.00% by the end of November, representing a yield decline of 190 bps from May 2007.

<sup>3</sup> Credit premium is defined as the extra yield of a debt instrument relative to a Treasury security having a similar maturity.

<sup>4</sup> Source: Bloomberg.

Most credit crises have been precipitated by rising private sector and emerging country defaults. In contrast, this current crisis has some unique characteristics:

- Corporate credit defaults<sup>5</sup> have remained relatively low, although they are projected to increase over 2008.
- Emerging market debt performed well in 2007.<sup>6</sup>
- Several money market funds<sup>7</sup> suffered principal losses and essentially “broke the buck.”
- Structured products (collateralized debt obligations, “CDO’s”), and structured investment vehicles (“SIV’s”) have generated most of the losses reported by financial institutions.
- The majority of credit impairments has involved US-originated debt but numerous non-US investors have suffered extensive losses.
- Hedge funds have become much larger players<sup>8</sup> in structured debt and credit-sensitive markets, providing liquidity but also inducing potentially more price volatility.

**Mortgage Meltdown: Poor Underwriting, Too Much Leverage, and Asset Price Disconnect**

Sub-prime and alternative-A<sup>9</sup> mortgages had been originated in large volumes as recently as 2006<sup>10</sup>. Sub-prime mortgages are estimated to represent

<sup>5</sup> Moody’s in Dec. 2007 estimated the global high-yield default rate to increase from 1% to 4.2% by the 2008 year-end.

<sup>6</sup> The JP Morgan Emerging Markets Bond Index returned 5.62% year-to-date through Nov. 2007 vs. 1.89% for the Merrill Lynch US High Yield Index.

<sup>7</sup> Bank of America (Columbia funds), Federated Investors, Legg Mason and General Electric.

<sup>8</sup> Greenwich Associates has estimated that, over a 1-year period ended April 2007, hedge funds generated nearly half of the trading volume involving structured credit in the US.

<sup>9</sup> Subprime mortgage investments include 1st mortgage liens with lower credit scores (i.e., below 620), 2nd lien mortgages, home equity lines of credit, minimal documentation loans (Alt A) and investment property loans. 2nd lien piggyback loans comprised 22% of all mortgages originated in 2006, up from 12% in 2004.

<sup>10</sup> Inside Mortgage Finance estimated that sub-prime mortgage originations were \$600 B for 2006 and \$665 B for 2005. Year-to-date through Nov. 30, 2007, sub-prime origination volume had declined to \$179 B. The Wall St. Journal has estimated that high yield mortgages comprised 29% of all mortgages issued in 2006 and that financial institutions in total issued \$1.5 trillion in high rate mortgages from 2004 to 2006.

12% of the present US mortgage market of \$10 trillion. Approximately 70% of sub-prime mortgages are held in structured securities. The sub-prime market started to take off substantially in 2004 due to rising home prices, ample liquidity manifested in low funding costs, and relaxed lending standards.

Using cheap funding and rising home prices (prices nearly doubled in the seven years to September 2006), Wall Street ramped up issuance of structured mortgages. Some more recent vintages have experienced the highest past due frequencies. While home prices began to drop in 2006, Wall Street continued to package poorly underwritten mortgages in securities with minimal restraint through mid-2007.

The sub-prime mortgage collapse was triggered by the unwinding in July 2007 of two Bear Stearns leveraged mortgage funds, costing investors \$1.6 B in losses. As the Bear Stearns funds suffered redemptions and collateral calls, the falling CDO prices underscored the disconnect between market-based prices and recorded fair book values. CDO pricing is made even more complicated by the presence of multiple tranches.

We expect the mortgage market to suffer further in 2008 as Lehman Brothers projects that 2.8 million mortgages will reset in 2008 with 3.6 million more mortgages resetting during 2009. With falling home prices, some estimate<sup>11</sup> that more than 10% of all mortgages have zero or negative equity backing in the related home values.

The capital markets generally allow issuers and investors to interact effectively in allocating risk capital. However, occasionally informational diseconomies result in mis-allocated capital. Here the rating agencies were in part to blame by assigning too-high ratings to the asset-based commercial paper issued by SIV's.

### Assessing the Fall-out from the Credit Crisis

It will take time to determine accurately the ultimate losses...and losers...from mortgage holdings. As of

mid-December 2007, financial firms had announced over \$80 billion in losses from mortgage-related investments. We expect that financial institutions will incur more losses in 2008 and many will be required to raise capital to maintain credit ratings and appropriate risk-based capital ratios. Some of the reported capital raising thus far is shown in the table below.

Company	Capital (\$ Billions)	Investor(s)	Type of Capital
<b>Citigroup</b> (C)	\$7.5	Govt. of Abu Dhabi	Convertible preferred
<b>UBS AG</b> (UBS)	\$11.8	Mideast and Govt. of Singapore	Convertible debt
<b>Freddie Mac</b> (FRE)	\$6.0	Various investors	Perpetual preferred
<b>Fannie Mae</b> (FNM)	\$7.0	Various investors	Convertible preferred
<b>Morgan Stanley</b>	\$6.2	Govt. of Singapore, Davis Select Advisors	Common equity
<b>Merrill Lynch</b>	\$5.0	China Investment Corp.	Convertible debt
<b>Countrywide Financial Corp</b> (CFC)	\$2.0	Bank of America	Convertible preferred
<b>E*Trade Financial Corp.</b> (ETFC)	\$2.55	Citadel Group	Debt and asset purchase
<b>MBIA, Inc.</b> (MBI)	\$1.0	Warburg Pincus LLC	Common equity
<b>CIFG Services Inc.</b>	\$1.0	Natixis SA (Parent company)	Common equity

The capital raised by financial institutions relates both to on-balance sheet and off-balance sheet assets. There had been a push by Citibank, JP Morgan and Bank of America, encouraged by the Treasury Dept. to create a "credit superfund" to take higher quality assets from bank-sponsored SIV's into an independent funding vehicle. This industry-sponsored initiative ultimately was not consummated as the larger banks assumed direct responsibilities for their SIV holdings by taking such investments directly onto their balance sheets.

<sup>11</sup> The Calculated Risk Blog. The site estimates that, if home prices decline 10% in 2008, homeowners with no equity will rise to 10.8 million.

**Fiscal and Monetary Responses**

The Fed moved initially in mid-August to lower the borrowing rate for financial institutions. The Fed subsequently has encouraged banks to borrow over longer periods and has expanded the set of permissible collateral backing borrowings. The Fed acted in December in concert with the Bank of England and the European Central Bank to assure an ample supply of liquidity to international financial markets and to make available US dollar-based assets to overseas investors.

Federal agencies have encouraged Congress to consider legislation or have used moral suasion to have mortgage investors and servicers offer low fixed rates to qualifying homeowners whose ARMs may be resetting over the next several quarters. These targeted homeowners are only a limited subset of ARM holders: mortgages originated over the last two years; borrowers current on payments; and borrowers who are likely to default under higher reset rates. The Federal Home Loan Banks (FHLB) have stepped into the void and increased their short-term note fundings by approximately \$160 billion from August through October 2007. In particular, Countrywide (CFC) borrowed \$51 billion through the Atlanta FHLB. Some of the regional FHLBs also have begun to offer longer-term loans, allowing borrowers to defer principal payments for up to 5 years.

Ultimately, federal agencies and Congress will have to decide what levels of moral hazard to accept for past investor behavior. The Fed through its active supply of liquidity in reacting to the 2001 US recession and its concern over declining price levels helped shelter the economy from the dot.com and tech bust and help prevent the evils of disinflation (remember that?). But it also helped supply the liquidity that fueled the explosion of mortgage products. Easy money, low qualification standards, and documentation fraud contributed to overinvestment in the real estate sector. A concern of many market participants is that continuing government intervention in the capital markets to dampen the fall-out from investor speculation and Wall Street origination sins will create similar expectations for government aid in the future. The fear is that similar cycles of excess investment and subsequent government action could create one-sided call options for investors and

originators, who are then incented to assume more risk against expectations that the Federal Reserve or the federal government will come to the rescue. Imprudent risk-taking and successive asset bubbles would likely result.

Rich Palmer, Los Angeles

**In The Face Of Rising Capital Gains Tax Rates**

No one should be surprised if federal tax rates on capital gains increase in 2009...even though Congress just recently extended the current 15% rate on capital gains and qualified dividends to 2010. Political pundits and economists seem to agree that no matter which party wins the White House later this year, so long as Democrats remain in control of both houses of Congress, some tax bill will be one of the first orders of business. Some commentators even think that tax increases would be wise. In any event, exactly when this would go into effect, and how rates for individual tax payers will be affected are details still unknown. However, it's not too early to begin to consider circumstances that might justify accelerating the sale or gift of highly-appreciated assets, this year, before they may be subject to higher capital gains tax rates in 2009.

There are at least a couple of cases where the answer to the acceleration question is probably "no". First, where the assets aren't needed for the current "senior" generation and will receive a basis step-up when passed to the next generations. Assuming, of course, that full basis step-up continues to be the prevailing regime. While a Democratic Congress almost certainly won't "repeal" the estate tax outright, as many Republicans want, some "death tax/income tax" compromise is possible and complete basis step-up could disappear. And second, where the assets are earmarked for future gifts to charity. In both of these cases, voluntary realization of capital gains this year is simply unnecessary.

For many other cases, the conclusions aren't so clear. For example, portfolio rebalancing, moving to new investment opportunities and/or preferred managers,

replenishment or expansion of cash reserves, and reducing concentration risk of a single security could argue for taking action sooner rather than later.

Determining whether accelerating capital gains makes sense requires exploration of the impact of several variables: the level of potential tax rate increases, size of the asset's embedded gain, expected future investment return...and, especially, the anticipated future investment timeframe. The longer you would expect to hold the asset, the less it makes sense to sell it now.

In the case studies below, we will share general insights and present case studies to demonstrate how these insights can be applied to help frame specific decision making. Should one of these examples raise a question about your own situation, please contact your client service team to discuss it in more detail. We, of course, look forward to assisting you on these and other important matters in the coming year.

### Scenario Planning

Our analyses compare the results of two different actions: accelerate sale at today's low capital gains tax rates, reinvest the after-tax proceeds in the *same* asset, and then sell again at some point in the future vs. continue to hold the asset now but then selling at that same future point, but at higher tax rates at that time. Future tax rates will be what they will be, but you can invoke today's *known* tax rates on the gains that currently exist. This comes at the cost, however, of taking that current tax liability out of the game as well as incurring the transactions costs of selling (early) and buying back. So, again, if you would be holding for a long time in any event, the lost opportunity on that current tax (and transaction expense) becomes a larger and larger cost.

Based on conversations with commentators at Stanford Policy Research, here are some possible tax rate scenarios.

**Best Case:** In the politically unlikely event that the current tax rates would be allowed to just expire at the end of 2010, the federal long-term capital gains top rate increases automatically from the current 15% to 20%. Knowing that a Democratic Congress could force this on the White House by simply doing

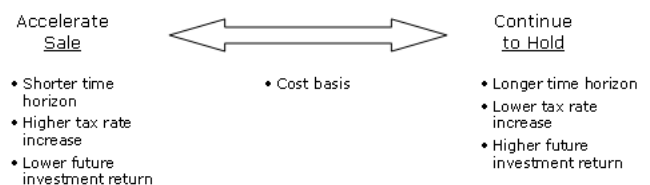
nothing, a Republican administration might need to compromise with a Democratic Congress on other matters and allow this top rate to increase even sooner. Consequently, we think 20% is the low end of the range of possibly higher rates.

**Worst Case:** Another argument says top rates could go as high as 28% should the Democrats – with a platform of new government spending (e.g., on health care) and higher taxes on the wealthy – be in firm control of Congress and the White House. We thus use 28% as the high end of our range of possible capital gains rates.

### General Conclusions

The diagram below attempts to summarize the general conclusions about the impact of key variables on the decision to accelerate or not.

**Unexpectedly, the cost basis of the asset does not change the calculated break-even holding period.** The cost of the current tax over that time frame exactly offsets the benefit of avoiding the future, higher tax on that current gain. It will, however, effect the cost of error. If your holding period turns out to be longer, in fact, than you anticipated, sales now of low basis holdings will be more costly than sales of high basis assets.



### Time-Frame Breakeven Points:

For a given investment return assumption, you can calculate a specific time frame at which you are indifferent to selling now, rebuying, and selling later, or just continuing to hold. The table below assumes an 8% pre-tax return for the asset under consideration. If your expected rate of return for the asset is greater, the break-even time frame is shorter (due to greater opportunity cost on the current tax amount). If the return expectation is lower, the break-even time frame is longer. This

tax optimization nicely coincides with what may be the investment optimization of the portfolio. A low returning asset is a more attractive candidate for the initial sale, for tax reasons alone, since the break-even time is longer. To optimize the investment return, maybe the proceeds should be used to invest in something else.

On that 8% return assumption (again, regardless of basis!) you should sell assets in 2008 if your holding period is anticipated to be *less* than the breakeven listed in the chart below. In all cases, if your holding period is expected to be more than 10.3 years, it is unlikely an accelerated sale of assets is warranted.

	Federal Tax Only	Federal + California Tax*
If the new federal tax rate is...	The breakeven holding period is...	The breakeven holding period is...
20%	4.5 yrs	3.3 yrs
25%	8.3 yrs	6.6 yrs
28%	10.3 yrs	8.4 yrs

\* 9.3% state tax rate.

So, a California tax payer who expects tax rates to increase to at least 20% and would expect to sell within three years in any event should sell now.

These perhaps surprisingly shorter break-even periods, when a large state tax is taken into account, result from the smaller *relative* changes: a 5% increase in rates is a larger change on federal rates alone than it is on the combination of federal rates and already high California rates. Said another way, Nevada residents would experience a greater *relative* change than California residents and, everything else equal, would be wiser to sell now.

### Example 1: Gifts to family members

In most circumstances, we advise our clients to give either cash gifts to family members...or to give appreciated assets in vehicles (see the article on Defective Grantor Trusts) that retain the donor's income tax liability...in order to avoid pushing the tax liability to the recipient. Should you be contemplating making such a gift in the next several years, and would be selling appreciated assets to raise the cash or to liquify the trust asset, it may make sense to do that sale in 2008.

### Example 2: Sale of a concentrated position

If you are holding a highly-appreciated, concentrated position in an individual security, 2008 is a good year to revisit your plans. Everything else equal, 2008 will likely be a better year to get on with diversification plans than to continue to wait. Viewed another way, this is an example of a very short anticipated time frame. If the position should be diversified in any event, the anticipated time frame for holding it should be zero!

### Example 3: Replenishment and/or expansion of cash holdings

Some of our clients, especially retirees, hold substantial cash reserves, which we replenish periodically. Following 5 years of strong equity returns, 2008 may be a good year to replenish these reserves at a lower tax cost than may apply in 2009 and beyond.

### Example 4: One-time, opportunistic rebalancing

If a relatively significant infusion of new, *tax deferred* assets is expected in the portfolio in 2009 (for example, due to retirement), it's possible we should rebalance some of the *taxable* assets this year, if the optimization of the overall investment portfolio can't be accomplished solely through movement in the tax deferred assets. For example, where the tax deferred account's existing investment choices have been extremely limited or are sub-optimized from a location perspective (e.g., the tax deferred account currently holds relatively tax-efficient assets while tax-inefficient assets reside in the taxable accounts).

### Example 5: Ongoing rebalancing and manager changes

As we near the end of a tax year, we typically delay ongoing portfolio rebalancing and manager changes that would result in the recognition of capital gains in the current tax year, in order to push the tax cost to the following tax year. Ten or eleven months from now, as we near the end of 2008 and face higher tax rates (by then, we'll probably have a much better idea of whether and by how much than we do now),

we may actually decide to *accelerate* such moves in order to lower the tax cost of doing so.

Linda Fitz and Karen Blodgett, San Francisco

## Investment Essentials: Food and Water

We don't often think of these crucial components of life as giving rise to investment opportunities, but after a moment's reflection, it's obvious that they do. Here are a few of our thoughts on these key topics.

### Agriculture

Over the past thirty years, agriculture has not been a hotbed of investment activity. Happily, for world-wide hunger...unhappily, for the obesity epidemic... food prices on world markets have fallen by three-quarters in real terms. The corresponding decline in farming revenue has been a hot political topic in both the United States and Europe. This past year's action in agricultural markets is, thus, very unusual. Wheat prices have doubled and almost every other agricultural commodity achieved record highs during the past year.

In the US, there were a number of weather-related and other, one-time, events which have pushed prices up. But commodities analysts do not expect prices to rapidly revert as they have in the past. There are two explanations offered for this secular bullish view of agricultural prices: growing wealth in emerging economies and political forces.

The primary reason for the possible continuation of agricultural inflation ("agflation") are the long-run changes in diet that accompany the growing wealth of emerging economies — e.g., the Chinese consumer whose consumption of meat has grown 150% since the mid-1980s. Demand for protein in turn pushes up demand for grain and other cereals — it takes 8 pounds of grain to produce one pound of beef.

But the rise in US prices, particularly corn, is also the self-inflicted result of our ethanol subsidies and speculation regarding alternative fuel. In 2007 biofuels consumed a third of our (record) corn

### Exchange Traded Note (ETN) Tax Treatment Threatened

As we have [discussed previously](#), we generally implement clients' allocations to commodities using an exchange traded note ("ETN") issued by Goldman Sachs. The return of the note is linked to an enhanced commodity index and currently enjoys favorable tax treatment relative to commodity mutual funds. As we expected, this tax treatment has come under some scrutiny by the IRS and Congress and may change as the result of IRS rulings or legislation.

If there were a change in the tax treatment of ETNs generally, it is unclear whether that would affect our existing positions. They might be grandfathered. However, even without that, since tax efficiency is only one benefit of the note, we do not expect to switch to another vehicle unless there is a material adverse change.

production. Demand for biofuel not only affects the market for corn directly, but also indirectly as farmers switch to corn from other crops. The 30 million tons of corn going to ethanol in 2007 amounts to half the decline in the world's overall food grain stocks.

In the longer run, new farmland could be put into production and new, more productive technology could be employed. These are the now familiar rescues to the Malthusian threat.\* But much of the new available land is in remote parts of the world, requiring big investments in roads and other infrastructure. Precious forests could also be in danger. And some of the new land — dry, marginal areas of Africa, Brazil, and Central Asia—could be vulnerable to damage from global warming. According to some reports, global warming could cut world farm output by as much as one-sixth by 2020.

We hesitate to be alarmist about this. Malthus has been proven wrong many times over. It is risky to predict long-run trends in farming—technology in particular always turns out unexpectedly—but most forecasters conclude from these demand and supply

\* Put simply, Malthus argued that population (demand for food) increases geometrically and outpaces the arithmetic ability to supply. Population must, therefore, decline (starvation) to match available supply.

currents that, at least, prices will stay high or go higher for as much as a decade. Because supplies will not match increases in demand, the International Food Policy Research Institute believes, cereal prices will rise by between 10% and 20% by 2015. The UN's Food and Agriculture Organization's forecast for 2016-17 is slightly higher. This year's agflation seems unlikely to be, as many past rises have been, simply the upward side of a spike with a downward side quickly to follow. We believe that we are at a new level.

### Water

There are two challenges facing the world's water consumers. First, population growth in dry areas has expanded rapidly. In the US, the population of the seven states that depend on the Colorado river grew by 10% between 2000 and 2006, compared with only 5.6% in the rest of America. And much of the growth is in the driest parts of even those states.

Second, much of the world's population does not have access to clean water and getting more water to them will be hard. China has over 20% of the world's total population and just 7% of the fresh water on earth. The United Nations has identified China as one of the 13 countries with the lowest water per capita in the world. It is estimated that half of China's population consumes contaminated drinking water on a daily basis and less than 15% of China's population has safe drinking water from a tap.

Part of the answer lies in redistribution. Even in California, by far the most populous state in the West, four times as much water is used by farming as is used by household consumers. Some of California's irrigated crops make sense, others certainly do not. Redistributing water resources away from inefficient farming to consumers seems probable and desirable over the long run, but overcoming the political barriers to such change has proven very difficult in the past.

### Investment Implications

While we enjoy the intellectual stimulation of our research into macroeconomic dynamics, our primary task is to develop investment strategy and execute investment implementation for our

clients. For example, we currently provide modest exposure to food, agricultural commodities, and water indirectly through broad-based equity and commodities vehicles, owning food exposure through big agribusiness in large cap domestic stocks such as Archer Daniels Midland and directly through a commodities asset class allocation. And a number of water utilities are part of the small cap exposures, including Aqua America (WTR) and American States Water (AWR).

We are unlikely to add concentrated investments to client portfolios which are essentially speculations on the spot price of food and water. Even our commodities strategy, for example, is expected to generate an attractive return even if the commodities' spot prices remain exactly the same.

We look forward to continuing to share our research into these and other powerful macroeconomic trends and will continue to look for ways to bring their positive impacts to the benefit of our clients' portfolios.

Jason Thomas, Ph.D.  
Chief Investment Officer, San Francisco

## Beyond The Shredder – Identity Theft Protection Services

With over 8 million identity theft victims each year, simply being careful to shred credit card offers and keep your personal information in a safe place might not be enough. Thieves are growing more sophisticated. This makes diligently protecting yourself even more important.

### Protection – the next level

You already know the basics: keep your personal information safe; protect yourself online; shred credit card offers, old receipts and statements. (Please see Avoiding Identity Theft for a comprehensive list of things you can do to prevent identity theft). Beyond the household shredder, how can we take identity protection to the next level?

*Place fraud alerts or credit freezes on your credit reports.* A "fraud alert" is a signal placed in your credit report to warn potential creditors that they must use "reasonable policies and procedures" to verify your identity before they issue credit in your name. A "credit freeze" means that potential creditors will be barred access to your credit file.

Under the Fair Credit Reporting Act, you may be entitled to two kinds of fraud alerts: initial and extended. Both alerts are free of charge.

*Initial fraud alert* is what you request if you suspect, but are not yet sure that you have had your identity stolen, or are simply concerned about your everyday exposure to identity theft. It's good for 90 days and can be renewed. To place an initial fraud alert, call one of the three national consumer reporting companies toll-free. The company you select is required to contact the other two, and they will place an alert on your credit report.

Equifax: 1-800-525-6285 or [www.equifax.com](http://www.equifax.com)

Experian: 1-888-EXPERIAN (397-3742) or [www.experian.com](http://www.experian.com)

TransUnion: 1-800-680-7289 or [www.transunion.com](http://www.transunion.com)

An *extended fraud alert* can be requested ONLY if you have already been a victim of identity theft and have filed an Identity Theft Report with the police (you don't ever really want to be eligible for this). The extended alert will stay on your credit report for 7 years. If your credit report has an extended fraud alert, potential creditors must contact you in person, or by phone or some other method you specifically provide before they can issue credit in your name. Furthermore, consumer reporting companies must remove your name from marketing lists for pre-screened offers of credit for 5 years.

*Credit freezes* go further. They allow you to completely restrict all outside access to your credit report, as opposed to permitting creditors access as long as they verify your identity, as in the case with fraud alerts. Formerly available to residents of only 10 states, as of November 1, 2007, credit freezes are now available to residents of all states. If you place a freeze on your report, potential creditors or others can't get access to it unless you lift the freeze either

temporarily or permanently. If you are a victim of identity theft and you have filed a police report, you can get a credit freeze free of charge. Otherwise, it costs approximately \$10 per credit reporting company (\$30 total if you freeze your report with all 3 companies).

If you anticipate opening a new account, submitting a mortgage application, or any situation where your credit report will need to be reviewed by a creditor, you can ask the credit reporting company to lift the freeze temporarily for a specific period of time and for a specific creditor. This will cost an additional \$10 per reporting company and will require some lead time, so it is a good idea to check with the company well in advance.

To place a freeze on your credit reports, contact the credit reporting companies listed above or go to [www.privacy.ca.gov/sheets/cis10securityfreeze.htm](http://www.privacy.ca.gov/sheets/cis10securityfreeze.htm) for detailed instructions, including sample letters to send to the companies requesting the freeze.

*Remove your name from pre-approved credit card solicitation lists.*

Similar to the National Do Not Call Registry that the FTC began enforcing in 2003, you can have your name removed from mailing lists or pre-screened offers for credit cards or insurance. These mailers are popular targets for identity thieves who steal mail or rummage through garbage cans for discarded offers. They use these offers to open up credit cards under your name and proceed to wreak havoc on your credit, unbeknownst to you until collection agencies come knocking. To remove your name from these lists, simply call 888-5-OPTOUT (888-567-8688) or go to [www.optoutprescreen.com](http://www.optoutprescreen.com).

*Review your credit report at least annually.*

One of the best ways to protect yourself is to monitor your credit history via your credit report. You are entitled to one free credit report from each of the three credit reporting companies every year. You can order them every year at the same time or stagger them so you receive one report every four months during that year. To order your free credit reports, go to [www.annualcreditreport.com](http://www.annualcreditreport.com).

### **Do it yourself or pay someone to do it for you?**

So now that we know what we can do to protect ourselves, will we really do all of these things and, importantly, be mindful of renewing our efforts on a regular basis? Some will be very diligent, while others might be more sporadic, leaving windows of opportunity for thieves. If you fall into the second category, you might consider hiring an identity theft protection service.

LifeLock and TrustedID are two firms to consider. They have the highest consumer ratings on websites such as [www.ConsumerCompare.org](http://www.ConsumerCompare.org) based on the services they provide, customer service, and price. They charge between \$9 and \$13 per month, or slightly reduced annual rates (\$110 on average), for their services.

#### *What do they do?*

Both LifeLock and TrustedID provide identity theft prevention. Within moments of signing up for their services, they place fraud alerts on your credit file and automatically renew these alerts every 90 days. They also remove your name from the pre-screened mailing lists for credit card offers. Both companies will order your free credit reports from each of the three agencies on your behalf for you to review and monitor your credit. Finally, if a thief still manages to steal your identity, both companies guarantee up to \$1 million in services and reimbursements to remedy the incident. Direct monetary losses from identity theft are typically much less than this guarantee, and, of course, you are not legally responsible for paying fraudulent debt incurred by a thief. It's the time and effort it takes to restore your good credit that is the real cost of identity theft. This can sometimes require the services of professionals such as attorneys and credit counselors, both of which are covered by the guarantee.

Since it was founded 2 years ago, LifeLock has grown to be one of the largest providers of identity theft protection services to individuals and businesses. Based in Tempe, Arizona, LifeLock's customer service is available 24/7, but the website offers no on-line account services. Therefore, you will need to contact them via telephone to make any changes to your account. LifeLock argues that this provides an

important element of security by not enabling online access: thieves cannot hack into your online account. LifeLock's CEO is so confident in his company's service that he publishes his Social Security number across the Wall Street Journal and the internet. Not surprisingly, this taunt resulted in his identity being stolen, but LifeLock's guarantee covered his costs.

Also founded in 2005, Silicon Valley's TrustedID is considered to be the other big name in identity theft prevention. Although customers can log onto their accounts online, the ConsumerCompare.org rated TrustedID's customer service significantly lower than LifeLock due to the limited service hours (Monday through Friday 7:30 AM to 4:30 PM PST) and time spent on hold. TrustedID's signature product, called IDFreeze, has the same offering as LifeLock with a couple of additions. IDFreeze also includes credit card monitoring services to help detect if your credit card number has been stolen. You will receive an email or phone call if TrustedID finds signs of suspicious activity. Additional credit cards are easily added to your account online for this monitoring service. An optional service offered by TrustedID is CreditLock, their term for credit freeze. For an extra cost, \$10 per freeze, temporary lift, or removal of the freeze for each credit reporting agency, TrustedID will take care of this for you.

Beyond these two subscription services, note that credit card companies and homeowner's insurance policies often offer identity theft insurance coverage. Some homeowner's policies automatically include this coverage while others may charge an additional annual fee ranging from \$75 to \$200. As with the guarantees of Likelock and TrustedID, the insurance coverage includes reimbursement for many of the same expenses but this often is limited to \$25,000 or less. We can check your homeowner's policy to see if this is covered.

Our clients can, of course, afford to self-insure against the potential actual expenses associated with recovering from identity theft. The \$1 million guarantee offered by companies such as LifeLock and TrustedID is not itself sufficient reason to buy their services. The real reason to spend the modest \$110 each year is to minimize the risk of the actual identity theft itself and have competent assistance in dealing with the aftermath if it still does occur. Currently,

the consumer favorite appears to be LifeLock.

The sad statistics tell us that we need to protect ourselves from being victims of identity theft, whether we do it ourselves or hire someone to do it for us. Hiring a LifeLock or TrustedID may automate these preventative steps. However, if a thief does still manage to sneak through, please contact us immediately to add our assistance in resolving the situation.

Leigh Shimamoto, San Francisco

*Note: Kochis Fitz/Quintile is of course not affiliated with any of the companies mentioned in this article and we can make no representation regarding the fitness of their services to clients' individual needs.*

## Reducing Exposure To The Estate Tax: Defective Grantor Trusts

Long-term complete repeal of the estate tax is highly unlikely, so techniques designed to minimize estate and gift tax exposure remain very attractive for clients of substantial wealth who are prepared to make irrevocable transfers to family members or other beneficiaries.

### Intentionally Defective Grantor Trust (DGT)

In this technique, the irrevocable trust is deliberately structured so that the creator of the trust retains powers causing it to be "defective" for income tax purposes (i.e., any income earned by the trust is taxable to the creator or grantor rather than to the trust or the trust beneficiaries). Nevertheless, the trust is structured so that transfers to this trust are completed transfers for estate and gift tax purposes. This discrepancy between the two tax systems (income tax and transfer tax) creates many great opportunities for super-charged wealth transfer.

The traditional use of this technique involves the transfer of income producing property, or property likely to appreciate to the trust in exchange for a promissory note of "equal" value. As a result, the grantor "freezes" the value of the property transferred

to the trust and allows the majority of the income and any subsequent appreciation on the property to eventually pass to the trust beneficiaries without gift or estate tax on those incremental values. Further, to the extent the assets being contributed are held in an entity such as a family limited partnership, the transfer of the entity interests likely garner minority and marketability discounts that immediately reduce the value of the assets transferred. The total taxable estate is even further reduced since the trust rules require the grantor to pay the *income tax* liability of the trust, effectively allowing additional gift tax-free transfers annually.

As an example, assume you created a family limited partnership to hold a \$5,000,000 investment portfolio and retained the limited partnership interests. While you had planned to give small interests to your children annually, the value of the portfolio is rising too quickly and simply increasing your estate. Therefore, you would first create an irrevocable grantor trust for the benefit of your heirs and "seed" the trust with a small gift of property (say, 10% of the total amount expected to be contributed). While tax rules do not permit you to retain complete discretion over those trust assets, you do have the ability to maintain some indirect control and still achieve the estate tax benefits. You could just make a gift of the partnership assets to the trust, but this would come at a very large gift tax cost. Instead, you could *sell* the limited partnership interests to the trust in exchange for a promissory note bearing interest at the minimum prescribed rate (i.e., currently 3.58% for loans up to 9 years in term). Due to minority and marketability discounts on the limited partnership interests, the promissory note might reflect a 25% or greater reduction so the amount of the note might be \$3,750,000 or less. As a result, the underlying property need only produce a 2.7% pre-tax return (i.e., 75% of 3.58%) to cover the interest and any excess return passes tax-free to your beneficiaries. If the total pre-tax return on the portfolio were 10% per year, the excess accumulating in the trust for later distribution could be as much as \$345,000 per year – tax-free. To the extent the excess grows at the same 10% per year, the estate and Generation Skipping tax (GST) tax savings through compounding can be very substantial.

**\$5,000,000 of Assets with 10% Return, 25% Discount, & \$375,000 Initial Gift**

	10 Years		20 Years	
	No Plan	With DGT	No Plan	With DGT
Amount to Grantor*	\$9,229,638	\$2,998,526	\$19,275,067	\$2,093,252
Amount to Beneficiaries of DGT*	\$0	\$6,231,112	\$0	\$17,181,815
Estate Tax Savings	\$0	\$2,636,938	\$0	\$7,564,754
Potential GST Tax Savings	\$0	\$2,636,938	\$0	\$7,564,754
<b>Total Estate and GST Tax Savings</b>	<b>\$0</b>	<b>\$5,273,876</b>	<b>\$0</b>	<b>\$15,129,508</b>

\*Undiscounted Value

One of the additional benefits to the structure is its flexibility. To the extent the assets do so well that the trust contains more than you originally planned to transfer, the grantor trust nature of the trust can be relinquished and all future income taxes would be borne by the trust itself. In contrast, if the return on the investments is less than expected in any given year, the payments from the trust can be reduced to interest only. Alternatively, if you later decide that you would like to get back the specific assets originally transferred to the trust, you can freely exchange the asset with other property of equivalent value. All of these transactions, as well as the original sale and note repayment, would not create any income tax consequences for the grantor as long as the trust is a grantor trust, since the *income* tax law treats the trust and the grantor as identical.

**Comparing a DGT Sale with a Grantor Retained Annuity Trust (GRAT)**

Another technique often considered along with the DGT sale is a Grantor Retained Annuity Trust or GRAT. The reason for the comparison is that the technique is very similar to the DGT sale except that the grantor transfers property to the trust in exchange for an "annuity" as opposed to a note. There are key differences that might lead you to choose one over the other. First, the rules for the GRAT are taken explicitly from the Internal Revenue Code and therefore are legislatively sanctioned whereas the DGT sale is the product of cases and IRS rulings. The DGT sale, however, has been readily used for more

than 20 years and has seen few successful challenges. Second, the DGT sale requires that a separate gift be made to seed the trust and it is often suggested that the amount of the gift need be as much as 10% of the sale amount. In contrast, the GRAT annuity value can be increased enough to effectively reduce the taxable gift amount to zero. Third, the GRAT contains an automatic adjustment clause wherein the retained interest adjusts to the extent the value is incorrectly determined. With a DGT sale, if the valuation of the assets sold is successfully challenged, some additional gift tax may be created. While the DGT sale documents might employ a similar type of adjustment clause, the effectiveness of those clauses has not been determined.

However, the DGT sale has its own unique benefits. First, since the property is sold and no annuity retained, the grantor may allocate the generation-skipping transfer tax exemption to the original gift. As a result, unlike a GRAT, the DGT sale is an excellent technique to pass wealth not only to children but also to grandchildren. Often, the terms of the trust provide that the assets are made available to the children but, to the extent undistributed, pass down to successive generations without tax. Second, unlike the GRAT, the payments under the DGT sale are flexible such that as little as the interest owed...or as a much as the entire promissory note...can be paid in any year. Third, the GRAT rules require the grantor to survive the term of the retained interest for the assets to be completely excluded from the grantor's estate. With a DGT sale, the grantor need not meet any survival requirement and only the unpaid note is included in the grantor's estate upon death. Fourth, the GRAT does not permit the trust beneficiary to receive any of the trust assets until the conclusion of the retained term whereas the DGT trust beneficiary can have more immediate access.

As always, the chief factors in selecting among these techniques are your goals and the type of asset being contributed. If your goal is to have assets remain in trust for multiple generations, the DGT sale likely is a better option due to the generation-skipping potential. If the asset is difficult to value or subject to substantial valuation discounts, the GRAT, with its statutory adjustment clause, probably is preferable. If instead, the income from the asset is variable or the beneficiaries need more immediate access to the

trust assets, the flexibility of the DGT sale makes it the best alternative. In either situation, however, you can save substantial transfer taxes through proper design and implementation of these techniques. As we continue to assist you in your overall financial affairs, we welcome the opportunity to address these techniques in detail.

Clay Stevens, Los Angeles

### Investment Spotlight: Berkshire Hathaway Class B

Portfolio weight: varies from ~2-3% of typical client portfolios

Annualized Total Return as of 11/30/2007

	1 Yr	3 Yrs	5 yrs	7 yrs	10 yrs
Berkshire Hathaway Class B	31.9%	19.0%	14.2%	11.6%	12.0%
Russell 1000 Value	3.1%	10.9%	13.8%	7.6%	8.1%
S&P 500	7.7%	10.1%	11.6%	3.5%	6.2%

Over the past 10 years, Berkshire Hathaway Class B ("BRK.B") returned 12.0%, outpacing the Russell 1000 Value index by 3.9% and the S&P 500 by 5.8%. Berkshire Hathaway is managed by Warren Buffett and Charlie Munger, independent thinkers with a proven ability to recognize value and pursue a disciplined investment strategy. They have built a diversified portfolio of public and private companies, spanning a multitude of sectors including insurance, energy, and manufacturing. In the aggregate, Berkshire Hathaway's subsidiary companies generate annual revenues nearing \$100 billion and employ over 200,000 workers.

Berkshire's long term, value oriented investment approach is consistent with our firm's core investment philosophy. But beyond the efforts of most value investors who look for securities that appear under priced by some form of fundamental analysis, Warren Buffett takes this approach to another level by seeking meaningful ownership in quality companies that are effective at generating earnings. Mr. Buffett measures his success through gains in shareholders' equity rather than just increases in stock price.

Berkshire's recent purchase of a 60% stake in Marmon Holdings, from the Pritzker family, is an excellent example of this strategy. Marmon is an industrial conglomerate with business units that manufacture products like plumbing pipes and metal fasteners: it reflect Buffett's fondness for businesses with high barriers to entry and steady cash flow streams.

Stock prices, of course, are affected by supply and demand characteristics in the market; Buffet believes that those prices may deviate significantly from the "true" value of the company. Mr. Buffett is focused on building value for investors in the long run and believes that shareholders' equity is a more useful and stable measure of such added value. For example, in 2006, Berkshire Hathaway's shareholders' equity swelled by \$16.9 billion, which increased the per-share book value\* of Berkshire stock by 18.4%. Over the last 42 years, Berkshire Hathaway's Class A shares' book value has grown from \$19 to over \$70,000, a rate of 21.4% compounded annually. So, in contrast to our general preference for passive investment approaches in the public equity markets, our use of Berkshire represents a nod to the indisputable success of this particular form of "active" strategy, operating mostly in the private equity space. And, as we described in an [earlier comment on Berkshire](#), it permits our clients to participate in the huge float advantages of its insurance company assets.

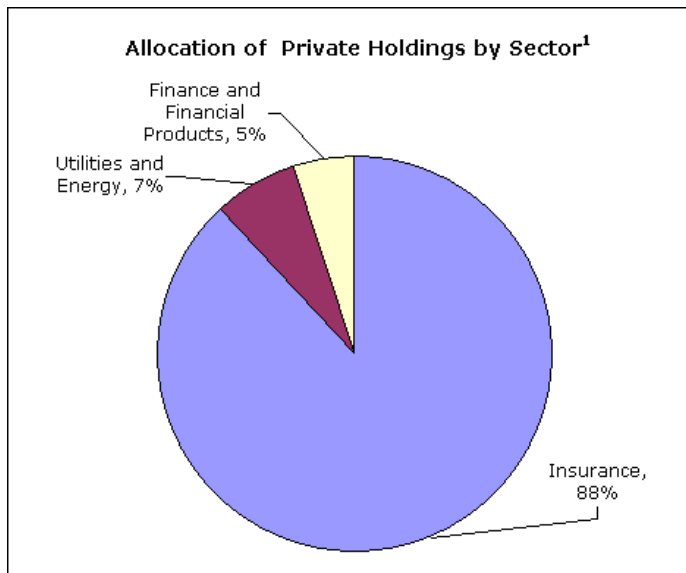
Many investors are concerned about leadership transition now that Mr. Buffet is 78 years old and Mr. Munger is even older: 83. Buffet has stated that two people will replace him. One will serve as Chief Investment Officer (CIO) and the other as CEO of the operating businesses. While their colleague, Lou Simpson, is a great candidate for the CIO role, with a successful investment record, he is only 6 years younger than Mr. Buffett. In the long-term, they will need to hire a younger person with the discipline and acumen to manage a very large and wide-ranging portfolio. We, like many other long term investors, will be attentive to this generational transition issue, but we have a good deal of confidence that the succession will be successful.

Currently, most of Berkshire Hathaway's earnings are generated by its insurance businesses. In 2006,

\* Book value is the net asset value of a company: total assets minus total liabilities.

these companies benefited from Mother Nature taking a break after the hurricanes of 2004 and 2005. Insurance companies collected large premiums and paid out very few insurance claims, making 2006 a very profitable year.

As of September 30, 2007, the approximate allocation of Berkshire's private holdings by sector is as indicated in the graph below:



<sup>1</sup> % of Portfolio's 3Q07 earnings before taxes and minority interests.

As of December 31, 2006, Berkshire Hathaway owned 73 businesses around the world. The largest public and private holdings in Berkshire are listed below:

The top five public holdings in Berkshire as of September 30, 2007 were:

Company	Percentage of Company Owned	Market Value (\$1000) of holding
The Coca Cola Company	8.7%	\$12,762,000
Wells Fargo & Co	8.3%	\$8,409,664
American Express Co	13.0%	\$7,927,724
Procter & Gamble Co	3.4%	\$7,822,093
Burlington Northern Santa Fe Corp	15.1%	\$4,446,695
		<u>\$41,368,176</u>

Significant private holdings in Berkshire as of September 30, 2007 were:

Company	Industry	% of Portfolio's 3Q07 earnings before taxes and minority interests
MidAmerica Company	Utilities and Energy	7.0%
GEICO (underwriting only)	Insurance	4.9%
Berkshire Hathaway Reinsurance Group (underwriting only)	Insurance	2.7%
General RE (underwriting only)	Insurance	2.3%
Shaw Industries	Carpet Producer	1.8%
Berkshire Hathaway Primary Group (underwriting only)	Insurance	1.1%
McLane Company	Food Service Distrib.	0.7%
		<u>20.6%</u>

### Selected Investments

The following investments are some key private holdings in Berkshire Hathaway:

**MidAmerican Energy Holdings**, based in Des Moines, IA, owns a wide variety of utility operations in the U.S. and UK. It has 3 operations servicing over 2 million electric consumers in Iowa and six western states. In the UK, Yorkshire Electricity and Northern Electric serve 3.7 million electric customers. In terms of natural gas, the company owns 2 pipelines which transport about 8% of the natural gas consumed in the U.S. In 2006, MidAmerica Energy Holdings generated \$348 million of earnings before tax and minority interests on \$3.5 billion of revenue.

**GEICO**, with headquarters in Chevy Chase, MD, is the fourth largest passenger auto insurer in the United States. The company provides automobile coverages to drivers in 49 states (Massachusetts is the only exception) and the District of Columbia. GEICO has been able to attract many customers by being a low cost provider. Between year end 2003 and year end 2006, the number of GEICO policies increased from 5.7 million to 8.1 million, a jump of 42%. In 2006, GEICO generated \$1.3 billion of earnings before tax and minority interests on \$11.1 billion of revenue.

**General RE Corporation** in Stamford, CT provides property & casualty reinsurance and life & health reinsurance coverages to clients worldwide. Its clients are usually insurance companies seeking to protect against the risk of excessive losses. The firm is represented in all major reinsurance markets through a global network of 50 locations, with over 2300 employees. General RE receives the highest financial strength ratings from A.M. Best and Moody's Financial. In 2006, General RE generated \$526 million of earnings before tax and minority interests on \$6.1 billion of revenue.

Monica Ma, San Francisco

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Los Angeles • San Francisco

## PERFORMANCE RESULTS

			4th Quarter 2007	12 Months to 12/31/07	3 Years Annualized to 12/31/07
Fixed Income	<i>Intermediate</i>	Benchmark Index: Lehman Brothers Aggregate Bond	3.0%	7.0%	4.6%
	<i>(Taxable)</i>	Benchmark Fund: iShares Lehman Aggregate Bond	3.0%	6.6%	4.3%
	*	<b>PIMCO Total Return Institutional</b>	<b>3.9%</b>	<b>9.1%</b>	<b>5.3%</b>
	<i>Intermediate</i>	Benchmark: Morningstar Muni CA Intermediate Category Avg.	0.8%	2.5%	2.7%
	<i>(Tax Free)</i>	<b>Vanguard CA Insured Intermediate Tax-Exempt Adm</b>	<b>1.1%</b>	<b>3.0%</b>	<b>3.0%</b>
Real Estate	<i>Global</i>	Benchmark Index: Dow Wilshire Global RESI	-11.5%	-10.7%	13.3%
		Benchmark Fund: 60% SPDR DJ Wilshire Intl RE/ 40% Vanguard REIT Index ETF	-11.4%	-10.7%	N/A
		<b>DWS RREEF Global Real Estate Sec</b>	<b>-10.7%</b>	<b>-7.6%</b>	N/A
	<i>US</i>	Benchmark Index: Dow Jones Wilshire US REIT Index	-13.5%	-17.6%	8.5%
		Benchmark Fund: iShares US Real Estate	-12.7%	-18.1%	6.5%
		<b>DWS RREEF US Real Estate</b>	<b>-12.6%</b>	<b>-15.5%</b>	<b>9.4%</b>
<i>Energy Infrastructure</i>		Benchmark Index: Citigroup MLP Index	2.4%	9.2%	13.8%
		<b>Kayne Anderson MLP</b>	<b>-5.4%</b>	<b>-5.7%</b>	<b>12.0%</b>
Large Cap: Domestic	<i>Blend</i>	Benchmark Index: S&P 500	-3.3%	5.5%	8.6%
		Benchmark Fund: iShares S&P 500	-3.3%	5.4%	8.5%
		<b>Schwab S&amp;P 500 Institutional Select</b>	<b>-3.3%</b>	<b>5.5%</b>	<b>8.6%</b>
		<b>Schwab 1000 Select</b>	<b>-3.1%</b>	<b>5.9%</b>	<b>9.1%</b>
	*	<b>Tax Managed Index Separate Account (Aperio)</b>	<i>Return based on individual client's portfolio</i>		
	<i>Value Style</i>	Benchmark Index: Russell 1000 Value	-5.8%	-0.2%	9.3%
		Benchmark Fund: iShares Russell 1000 Value	-6.2%	-0.3%	9.2%
		<b>Berkshire Hathaway B</b>	<b>19.8%</b>	<b>29.2%</b>	<b>17.3%</b>
	*	<b>DFA Large Cap Value</b>	<b>-5.4%</b>	<b>-2.8%</b>	<b>8.8%</b>
*	<b>DFA Tax Managed Marketwide Value</b>	<b>-6.2%</b>	<b>-1.8%</b>	<b>9.8%</b>	
Large Cap: Developed Overseas	<i>Blend Style</i>	Benchmark Index: MSCI EAFE	-1.7%	11.6%	17.3%
		Benchmark Fund: Vanguard FTSE All World ex US ETF	-0.8%	N/A	N/A
		<b>Vanguard Total International Stock Fund</b>	<b>-1.2%</b>	<b>15.5%</b>	<b>19.1%</b>
	<i>Value Style</i>	Benchmark Index: MSCI EAFE Value	-3.2%	6.5%	16.9%
		Benchmark Fund: iShares MSCI EAFE Value	-2.1%	7.2%	N/A
	*	<b>DFA International Value</b>	<b>-3.7%</b>	<b>10.2%</b>	<b>19.5%</b>
*	<b>DFA Tax Managed International Value</b>	<b>-3.3%</b>	<b>10.8%</b>	<b>19.9%</b>	

\* Preferential Access Through Kochis Fitz

Returns are stated net of manager's fees, but before Kochis Fitz fees. Figures in bold reflect performance equal to or better than benchmark fund or, in cases where the benchmark fund's performance is not available, performance equal to or better than benchmark index.

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Los Angeles • San Francisco

## PERFORMANCE RESULTS

			4th Quarter 2007	12 Months to 12/31/07	3 Years Annualized to 12/31/07
Small Cap: Domestic	<i>Blend Style</i>	Benchmark Index: Russell 2000	-4.6%	-1.6%	6.8%
		Benchmark Fund: iShares Russell 2000	-4.6%	-1.5%	6.7%
	*	<b>DFA US Small Cap</b>	-5.8%	-3.1%	6.2%
	*	<b>DFA Tax Managed US Small Cap</b>	-5.9%	-1.6%	<b>6.9%</b>
	*	<b>DFA US Micro Cap</b>	-6.9%	-5.2%	5.2%
	<i>Value Style</i>	Benchmark Index: Russell 2000 Value	-7.3%	-9.8%	5.3%
		Benchmark Fund: iShares Russell 2000 Value	-7.3%	-9.9%	5.1%
	*	<b>DFA US Small Cap Value</b>	-8.8%	-10.7%	<b>5.4%</b>
*	<b>DFA Tax Managed US Targeted Value</b>	-7.9%	<b>-8.5%</b>	<b>5.5%</b>	
Small Cap: Developed Overseas		Benchmark Index: MSCI EAFE Small Cap	-4.8%	1.8%	15.5%
		Benchmark Fund: SPDR S&P International Small Cap ETF	-5.2%	N/A	N/A
	*	<b>DFA International Small Company</b>	-5.6%	<b>5.7%</b>	<b>17.2%</b>
	*	<b>DFA International Small Cap Value</b>	-7.5%	<b>2.9%</b>	<b>17.7%</b>
Emerging Markets		Benchmark Index: MSCI Emerging Markets	3.7%	39.8%	35.6%
		Benchmark Fund: Vanguard Emerging Markets ETF	3.0%	39.1%	N/A
	*	<b>DFA Emerging Markets Core Equity Portfolio (inception date 4/5/05)</b>	2.1%	37.5%	N/A
		<b>Oppenheimer Developing Markets</b>	<b>3.8%</b>	33.9%	33.3%
		<b>SSgA Emerging Markets</b>	2.5%	<b>41.0%</b>	<b>37.2%</b>
	<b>T Rowe Price Emerging Markets</b>	<b>5.9%</b>	<b>42.9%</b>	<b>37.8%</b>	
Commodities		Benchmark Index: Goldman Sachs Commodity Index	11.6%	32.7%	12.2%
		Benchmark Fund: iShares GSCI Commodity-Indexed Trust	11.4%	31.4%	N/A
		<b>GSCI Enhanced Commodity Total Return Strategy Index ETN</b>	<b>11.8%</b>	N/A	N/A
		<b>iPath GSCI Total Return Index ETN</b>	<b>11.5%</b>	<b>32.0%</b>	N/A
		<b>Oppenheimer Real Asset Y</b>	11.1%	30.8%	<b>13.2%</b>

\* Preferential Access Through Kochis Fitz

Returns are stated net of manager's fees, but before Kochis Fitz fees. Figures in bold reflect performance equal to or better than benchmark fund or, in cases where the benchmark fund's performance is not available, performance equal to or better than benchmark index.

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