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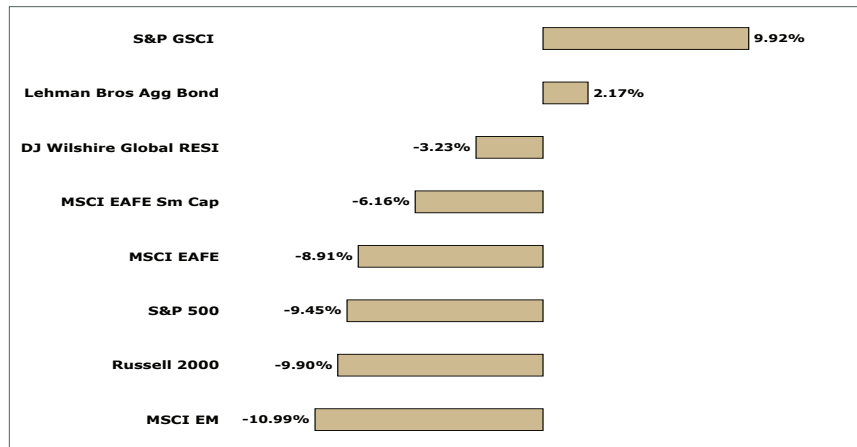
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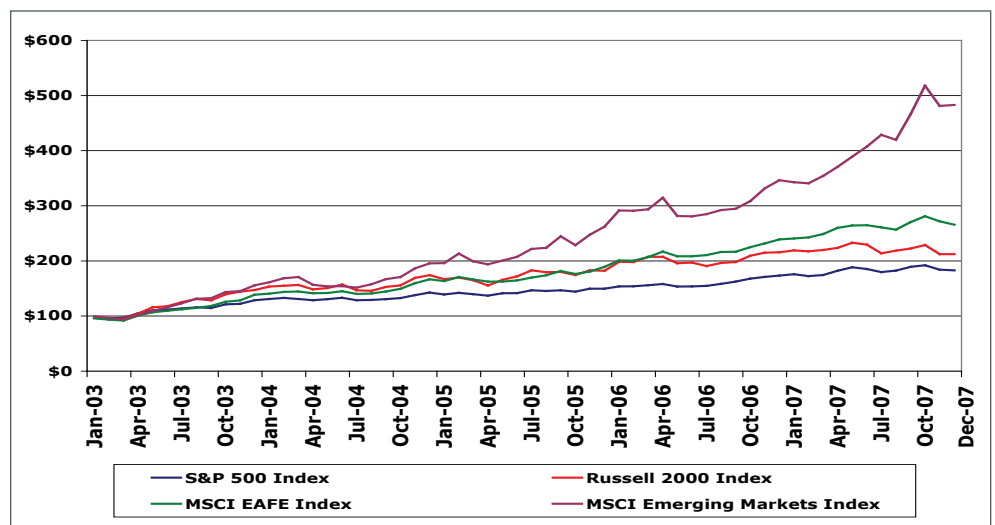
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A Difficult Start

The first quarter of 2008 witnessed poor performance in virtually all equity asset classes. Still, as a result of broad diversification and careful selection of specific investment vehicles, our clients' portfolios suffered a good deal less than major domestic market indices...and generally much less than alarmist media coverage would cause one to believe.



For clients with many years of experience with our patient, strategic investment approach, our consistent focus on long range expectations, with relatively little reaction to short-term disturbances, should ring very familiar. While this past quarter's performance is worse than we've seen in five years, it's important to remember how exceptionally good those intervening five years have been. Aggregate gains since 2003 through the end of 2007 were stunning, even with some quite poor quarters at the beginning and the end and along the way.



So, in context, declines in asset values from recent highs should be less concerning. These general declines since last October are well within the range of normal, periodic retrenchments and do not, themselves, give cause for changes in long term strategic placements. Further, the heightened day to day volatility in recent months, [there were 15 days this quarter when the commonly watched Dow Jones was up (5 days)...or down (10 days) more than 200(!) points] confirms the wisdom of our practice of not trying to "time" market movement. While *everyone's* temptation is to try to seize short term advantage by "doing something", logic and our experience tell us that no-one can *predict* a durable advantage from short term moves and history is eloquent that the cost of being wrong in those moves can be very great.

While we are very mindful of the several threats the domestic economy currently faces (heightened inflation, dollar weakness, still declining residential real estate values, a near collapse of some credit markets, failing brokerage firms, and the brink of a recession in the overall domestic economy), it's difficult for us to take a particularly pessimistic stance, even in the near term, from here.

Economic fundamentals around the world are reasonably strong, with *absolute* levels of employment high, inflation moderate, and production and consumption growing. With recent repricings in equities, real estate, and credit markets, current valuations will, we think, attract increasing interest. Add to this mix direct domestic fiscal stimulus and a Federal Reserve that seems determined to deploy old methodologies (rate reductions) and new (lending directly to brokerage firms as well as to commercial banks, and accepting mortgage paper as collateral) to maintain confidence in market mechanisms. These governmental responses are not without their own risks (even greater deficits, higher inflation potential, and moral hazard), but seem likely to prevent severe losses for investment market participants.

Beyond this very big picture, however, there are some important lessons from recent events that should help us continue to refine our approaches to specific areas of investment placements. In articles to follow, Rich Palmer describes some of the surprises that occurred in supposedly very low risk short-term debt

investments and Jason Thomas and Mike Fitzhugh discuss current insights on investing in developing markets.

Integration Update

The integration of our newly merged firm continues at an accelerating pace. We're planning a first gathering of the entire staff of both offices together early next month. Meanwhile, that staff continues to grow. Since the beginning of the year, we've made three additions: one to expand our investment strategies and research function and two to our senior level administrative personnel so our core client service staff have even greater support resources.

We've also made considerable progress in articulating our unified business strategy and its implications for some subtle changes to our internal organizational structure. Most importantly for our clients, we're making significant enhancements to our investment platform and to our planning approaches to quickly capture the intellectual and operational advantages our merger provides.

Lastly, we're about to launch our firm's new name, still largely "under wraps." We're very enthused about this opportunity to create a new public identity and are planning to go "live" in mid-May. This will be our last *Commentary* under the name Kochis Fitz/ Quintile.

As evidence of the merit of the key purpose behind this merger, to create a new firm, more resourceful and more durable than either of its constituents, we've all moved from some degree of remorse over losing our old names...to now looking forward to leaving them behind.

Tim Kochis, Editor

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Updates on China

As long time investors in emerging markets, we have followed developments in China for many years. Recently, we've attended a couple of interesting presentations on China and want to report on them to you. The Federal Reserve Bank of San Francisco hosted a presentation by David Loevinger, who is posted in Beijing as the Minister-Counselor for Financial Affairs at the US Department of the Treasury, and we hosted a meeting in our San Francisco office with Professor Burton Malkiel, most well known for his classic text, *A Random Walk Down Wall Street*. Malkiel is "on tour" now in support of his new book, *From Wall Street to the Great Wall*.

Malkiel sets the historical context for China's current charge up the rankings of national economies by noting that for centuries – and as recently as 1820 – China had by far the largest economy in the world, producing about one third of the globe's output. After complacency and humiliation in the 19th century, the Chinese suffered through its civil war, the Japanese invasion, and the period of Mao's rule. Currently China produces about 6% of the world's output (versus about 27% for the US), but is expected to become the largest economy in the world within 20 years. Its stunning growth rate will inevitably decline from the current 10% per annum, but will likely remain among the highest in the world.

China has and is continuing to invest vast sums to develop its infrastructure – highways, ship and air ports, power generation facilities, etc. Its powerful central government and lack of a free press has allowed the development of large projects largely regardless of the interests of adverse parties. The extension of infrastructure investment to the middle and western regions of the country is expected to unlock further underutilized economic resources. Meanwhile, China's age-old emphasis on education, underscored by the Communist Party's goal of literacy for the masses without regard for gender, has provided a huge, relatively productive workforce.

This progress has lifted many millions out of poverty and created a very large Chinese middle class. Even the profession of private "wealth management" has entered nominally communist China. Our CEO, Tim Kochis, serves as Chair of the International Advisory

Panel for the Financial Planning Standards Council of China.

China's recent growth has changed the entire calculus of world trade and could put China in conflict with other economic powers for scarce resources. China's leadership faces many serious internal risks as well. Income distribution has grown more skewed than it is in the US and is seen by the Chinese government as a potentially destabilizing threat, especially as media penetration increases. Similarly, corruption among government officials as well as in private enterprise remains an enormous obstacle to progress. Geopolitically, China's sometimes tense relations with Tibet, Taiwan, and Japan remain unresolved, though Ma Ying-Jeou's victory in the Taiwanese presidential election a few weeks ago may signal a dampening of Taiwanese sentiment for sovereignty.

Like the population of the US and other developed countries, the population of China is aging rapidly. As Loevinger put it, "China will grow old before it grows rich." But the Chinese have one of the highest savings rates in the world – reflecting both the need to provide for one's old age, and very low productivity of savings in the economy. The ability to lay off some financial risks via insurance products is poorly developed, and the national social safety net is still the family.

For those of you who find developments in emerging economies as fascinating as we do, we recommend *The Elephant and The Dragon*, by Robyn Meredith. Addressing India as well as China, the book elaborates on the historical context for the modern development of these two very different countries and discusses the many implications for the future.

Investing in China

The Dimensional Fund Advisor (DFA) Emerging Markets Core Equity fund (formulated, largely at the behest of our firm, in April 2005, as an amalgam of three previously separate DFA funds) is our primary vehicle for actually accessing Chinese equities for our clients.

To be eligible for inclusion in one of the DFA emerging markets funds, a country must demonstrate both commitment to a free market economy and a

sufficiently well developed stock market. On the first score, a country must have a sound legal system evidenced by property rights protection, the ability to enforce contracts, and reasonable treatment of foreign ownership (no unreasonable taxes, ownership restrictions or restrictions on repatriation of capital). On the second, the stock market (in the case of China, we're referring primarily to the Hong Kong stock exchange on which Chinese "H shares" are traded) must be well organized with a minimum \$10 billion in market capitalization, have ample liquidity, and a sufficient number of publicly traded companies. Prior to 2007, DFA judged that China and the Chinese stock market had not met these criteria. (Russia remains the other notable country whose market is not currently included in DFA emerging market portfolios.) Despite the fact that China's stock market was almost 12% of the MCSI Emerging Markets index (second only to South Korea's 16%), there were no Chinese stocks in the DFA emerging markets portfolios at this time last year.

After a series of legal reforms in China, DFA decided to begin adding listed equities of Chinese companies to its portfolios beginning in July 2007. At the end of February, trading had progressed to the extent that Chinese stocks were 9.7% of the Emerging Markets Core Equity portfolio's value. To mitigate single country risk, DFA maintains a 12.5% limit on the securities weight in the portfolio of any single country. Brazil is currently capped by that limit and South Korea, Taiwan, China, and India are expected to reach the limit over time. The complete exclusion of some countries (described previously) and the single country limit result in meaningfully different country weights, and therefore returns, between the DFA Emerging Markets Core Equity fund and those of published emerging market indexes. Recent returns are shown below.

	<u>Q1 '08</u>	<u>12 Months</u>	<u>Annualized Returns Since 5/1/05</u>
DFA Emerging Markets Core Equity fund	-10.23%	17.54%	28.42%
MSCI Emerging Markets index	-10.99%	21.33%	31.41%
MSCI China (component of MSCI EM index)	-23.69%	29.84%	41.93%

Consequently, our clients shouldn't be surprised if

our emerging markets performance differs (better or worse) from some commonly published measures. We believe that the benefits of these structural parameters will outweigh, over time, whatever "tracking error" occurs as a result.

This is, of course, only the beginning of opportunities for our clients to invest in China. Other...or additional... excellent fund choices may arise for investing in China's public markets and, eventually, we expect direct private equity investment opportunities as well.

Mike Fitzhugh and
Jason Thomas, Ph.D.

The Estate Tax Question: Nearing a Resolution?

We are constantly asked by clients about the future of estate taxes and how to plan accordingly. Unless something considerably more dramatic than what is on the horizon occurs, there will remain a great deal of merit in matching available strategies to individual client's facts, circumstances, and objectives in order to mitigate this potentially very large tax.

Since 2001, the rates and exclusions for transfer taxes have been changing and the road beyond 2011 is still uncertain. You'll recall that in 2001, legislation was passed to decrease the transfer tax rate and increase the exclusion amount concurrently over a period of 10 years...until 2011 when all changes would be repealed.

In 2001 the exclusion for lifetime gifts and estate transfers was \$675,000, with transfers above \$675,000 taxed at rates of up to 55%. Now, in 2008 the transfer tax rate is 45% and the exclusion is \$2 million for estates and \$1 million for gifts. The exclusion amount for estate transfers is scheduled to increase to \$3,500,000 next year (tax free lifetime gifts will still be limited to \$1 million of the \$3.5 million exclusion). In 2010, all estate transfers are scheduled to be estate tax free but only for that one year. Assuming no further legislation, the gift and estate tax rates are scheduled to be increased...and the exclusions reduced...to return to 55% over \$1 million in 2011. No one really expects these 2010 or

2011 situations to actually occur; something else will go into law before that...but what?!

A recently passed Senate Budget Resolution has shed some light on the possible future of estate taxes.

Conrad Teitell (a principal in the law firm Cummings & Lockwood; an adjunct visiting professor at the University of Miami Law School and director of the Philanthropy Tax Institute) provided some insight into what the Senate Finance Committee is thinking, and its potential timeline.

Mr. Teitell noted that the just-passed Senate "Budget Resolution", is, of course, a goal and not law — "but nevertheless significant for those who read tea leaves." Senate Finance Committee Chairman Baucus's amendment to the Senate Budget Resolution was the only estate tax amendment to pass; but it was approved 99-1. It would make the 2009 law permanent — a \$3.5 million exclusion (\$7 million per couple) with a 45% tax rate for amounts above those thresholds. Five other amendments were offered but not passed. The votes on the one successful amendment and the amendments manqués could foretell the bill that the Senate will eventually pass according to Mr. Teitell.

Here's an excerpt from the testimony of Mr. Teitell to the Senate Finance Committee (he was questioned by Senator Grassley):

"Senator Grassley (R. Iowa)

Mr. Teitell, as you have seen from the House and Senate debate over the last few years, there is a sharp division on what our long-term estate tax policy ought to be. There is a bipartisan group who would like to, at a minimum, ensure that the estate tax does not rise above the level set in 2009. The resistance to estate tax reform resides in the Leadership of the House and Senate majorities. If the Democratic Leadership agreed that, at a minimum, the estate tax would not rise above 2009 levels, would that provide clarity to estate planners like yourself? That is, clarity for the period between now and the time long-term estate tax relief is enacted?

Conrad Teitell

Mr. Ranking Member: I am sure that taxpayers and

their advisers would salute members of Congress who reach a compromise so certainty will reign for the foreseeable future.

With all due respect to members of both parties, the mood of the country on this issue — based on what I hear at my lectures on estate planning to professional advisers and laypeople across the country and my discussions with fellow professionals at estate-planning conferences — is that people are fed up with the Congress's inability to resolve this issue.

The present Congress can't, of course, by public statement or legislation, guarantee what a future Congress will do. But for now, passage before the summer recess of a revised estate-tax law with a \$3.5 million exemption (the 2009 exemption and rates alluded to in your question) would cure the current planning paralysis. The planning techniques sanctioned under current law — as well as the unlimited marital and charitable deductions — should be retained."

Due to the resounding majority Senate vote, 99-1, in favor of making the 2009 law permanent — a \$3.5 million exemption (\$7 million per couple) with a 45% rate, we might expect to see something close to the 2009 law in a future bill the Senate finally passes.

Additionally, in April the Committee plans yet another hearing, that will once again focus on the provisions of the current law dealing with deferral of payment of federal estate tax for small businesses, farms and ranches (IRC §6166), special use valuation for farms and ranches (IRC §2032A), reunifying the gift and estate tax exemptions (today, in 2008, the gift exclusion is only \$1 million; the estate tax exclusion is \$2 million), and portability of the gift, estate and generation-skipping tax exemptions (a surviving spouse could use the deceased spouse's unused exemptions).

Mr. Teitell indicated further that given the "overarching concern ... in how small businesses, farms and ranches would be treated under the proposed alternative tax systems"...by many of the high ranking Senators on the Finance Committee, "you can bet the farm, ranch and small business that their exposure to estate taxes will be further shielded."

Still, for most of our clients, such provisions and these anticipated levels of allowance and rates will not provide much real escape from substantial transfer tax exposure.

Ken Anderson

Credit Market Surprises

"If past history was all there was to the game, the richest people would be librarians."
Warren Buffett

Credit Concerns Reach "Low Risk" Sectors

In our last quarterly Commentary, we discussed the nature of credit cycles and market characteristics associated with cycle phases. We focused then on the direct fall-out from the present mortgage financing crisis and the resulting impact upon financial institutions that had underwritten and retained substantial volumes of mortgage-related securities. Some consequences of the credit disruptions, such as substantial declines in share prices for financial institutions and much wider yield premiums for corporate and mortgage debt, were somewhat predictable. What was difficult then to foresee were the extent and severity of the further consequences of attempts to reduce credit risk.

Since we published our last Commentary, there have been a number of financial events that have surprised many investors: the sudden failure of Bear Stearns; the Fed's decision to lend directly to broker-dealers, using an expansive, eligible collateral set; auction failures for most of the municipal auction rate securities (ARS) market; and significant market-to-market losses incurred by "ultra short" debt funds. We will focus on the last two of those surprise events... how it came to be that supposedly short-term, high-credit grade instruments, frequently marketed as "money market" alternatives, would suffer from a combination of illiquidity and actual market valuation losses. Investors have found themselves unable to liquidate ARS holdings. Other investors are facing non-trivial losses in short-term, high quality debt funds. Both markets are likely to undergo major changes from here with a possible outcome for the ARS market being its near elimination (with a possible

exception for auction rate preferred securities associated with closed-end funds). Investors will now be much more circumspect regarding credit and price risks contained within supposedly ultra-short debt funds that offer "enhanced" yields.

What happened to cause such wide-spread liquidity and pricing dislocations in these two security types that had exhibited both relative price stability and liquidity over prolonged past periods, and is there a particular villain? In our view, all of the players in the capital markets (fund managers, investment banks, dealers, rating agencies, and of course, the investors themselves) bear some responsibility for weak underwriting and due diligence efforts that provoked the current credit crisis.

Auction Rate Securities: A Near Market Extinction Event

Prior to 2008, there had been relatively few ARS auction failures, despite an overall ARS market that had grown to approximately \$330 Billion.¹ ARS are long-maturity securities whose yields are reset through periodic auctions (7 to 49 days in frequency) and whose auctions are managed by re-marketing agents. Despite the fact that ARS dealers had been paid an annualized 20 to 25 basis points to conduct ARS auctions in an orderly manner and to ensure that investors wishing to redeem their shares could do so, liquidity largely disappeared from the ARS markets as dealers would no longer commit their balance sheets to cover sell imbalances. As a consequence, hundreds of failed auctions in a largely consecutive fashion constituted a "Black Swan"² event during this 1st Quarter, resulting in investors mostly not being able to redeem their shares. As of late March 2008, about 70% of auctions continued to fail, meaning that investors who wish to redeem some or all of their shares could not do so fully through the auction process. As a result, ARS rates had increased on average to 6.6% (tax-exempt) in mid-March, up from the mid-3% range in January 2008. Failed auction

¹ Of the \$330 billion, \$80 billion is associated with student loans, \$80 billion involves debt and preferred securities issued by closed-end funds and the remainder has been issued by municipal authorities and conduits.

² Reference is made to the book, *Black Swan*, by Nassim Nicholas Taleb. This book discusses with outlier events and the inability of learned forecasters to predict the occurrence or the sources of such outlying events.

rates vary widely among ARS, with some issuers paying rates well over 10%.

Happily, tax-exempt money market funds have not been directly affected by auction failures in the ARS markets. These funds have not been allowed to hold ARS as they have not been deemed to be eligible investments for MM funds. ARS do not have mandatory put features or a letter of credit, issued by a suitably rated bank, that would allow, under all circumstances, an investor to put back an ARS security to a liquidity provider on the assigned auction date.

"There's no such thing as a free lunch."

Milton Friedman

Enhanced Yield Funds: Mislabeled Risk

In a manner similar to investors reaching for more yield in the ARS markets, taxable debt investors have used "enhanced yield" funds, categorically described as "short-term" or "ultra short", to improve portfolio yields above those offered by true money market funds. Investors discovered in the 1st Quarter that higher yields can come with substantial additional risks. Some enhanced yield debt funds, despite being labeled as short-term and investment-grade, contained both illiquid assets and asset-backed holdings that were subject to substantial price risk, despite being designated as relatively insensitive overall to interest rate changes due to their very low duration. Some enhanced yield, ultra short funds sustained price losses over the 1st Quarter in the range of 10% or more, despite having stated interest rate durations of less than 2 years. Even longer duration (i.e., more interest rate sensitivity) portfolios had better returns than supposedly less volatile enhanced yield funds. The issue, as it turned out, was not interest rate risk but substantial *credit* risk, unmasked only when the capital markets became stressed.

Enhanced yield funds that contained substantial exposures to asset-backed investments sustained losses as asset-backed yields increased substantially over the last several months. As such asset-backed paper typically had yields determined from periodic resets (i.e., LIBOR + 1.00%, reset quarterly), the debt was characterized as "short-term" in nature.

The cascade of events that led to ARS auction failures began with the melt-down in the subprime mortgage markets in the 3rd quarter of 2007. Monoline bond insurers, such as Ambac Financial Group, MBIA Inc. and FGIC Corp., had diversified away from their traditional business of insuring municipal bonds and had ramped up their insurance coverage of structured securities, including collateralized debt obligations (CDO). Many of the CDO's for which the monoline insurers provided insurance for specific tranches contained significant exposures to sub-prime and alternative-A (i.e., low documentation) mortgages. Although the monoline insurers had provided insurance for only the most highly-rated tranches (e.g., AAA) of CDO's, much higher-than-expected mortgage default rates caused many of the insured CDO tranches to fall in price. The rating agencies (e.g., Moody's, Standard and Poors', Fitch) became concerned that funds available at the monolines to cover potential losses were not compatible with their AAA credit ratings. Already, Fitch has lowered the ratings of the Ambac insurance subsidiary to AA and has recently downgraded FGIC to below investment grade with a BB rating. Both Moody's and Standard & Poors' have placed Ambac and MGIC on credit watch for possible downgrade although their credit ratings have been maintained at AAA.

Broker-dealers and individual investors had become dependent upon bond insurers for default coverage of credit exposures, both in and away from the municipal markets. For the municipal markets, despite their very low historical default rates, monoline insurers had insured 50% or more of newly issued securities over the last several years. Many investors, retail, brokerage and institutional, had come to rely on insurance for their purchase decisions without fully understanding the underlying credits. With the potential for credit downgrades for the monoline insurers, investors suddenly started to focus more on the underlying credits. This reassessment of holdings and investment choices caused investors to sell certain securities and for broker inventories to grow when their capital and their liquidity were under pressure due to substantial credit losses and inventory write-downs across a broad set of market sectors. Many insured issues with lower investment grade ratings (e.g., A or BBB) are actually trading as if the insurance wrapper has no value.

The reality is that increasing *credit* spreads over the reset rates caused price declines for these instruments that were more representative of fixed rate, longer maturity debt. The *effective* duration for such asset-backed investments was much longer actually than the quoted nominal durations, resulting in much higher-than-expected price volatilities. While multiple investment companies have taken action to avoid “breaking the buck” for money market funds, investment companies have not committed to offsetting investor losses to any extent for enhanced yield, short term fund investments.

“Turbulence is life force. It is opportunity. Let’s love turbulence and use it for change.”

Ramsey Clark

Understanding and Accepting Risks: Portfolio Framework for Risk-Return Trade-offs

While we have focused on shorter-term asset sectors to illustrate adverse outcomes due to market dislocations, we always seek to focus attention on *overall* portfolio risk and where risk-return trade-offs are more likely to be favorable. For the most part, accepting more risk for cash or cash-equivalent positions is not an effective use of the portfolio risk budget. As these recent developments show, short-term investment risks can be misinterpreted or even misstated substantially. Sudden market dislocations can cause credit spreads to widen, resulting in both price declines and a significant diminution of liquidity even for shorter term, highly rated debt instruments. Instead, risks are much more amply rewarded over the long-term from allocations to longer-term bonds, and, of course, equities and other higher risk asset classes. There simply has not been enough of an interest rate differential in ARS and enhanced yield funds to offset potential price changes and a loss of liquidity from relatively quickly changing investor risk preferences.

Further, some clients could choose to allocate portfolio risk more effectively to opportunistic situations, resulting from market dislocations that are temporary in nature (although perhaps lasting for several quarters). Spreads have widened substantially for credit-sensitive sectors (i.e., investment-grade corporates, agency mortgages, municipal investment-grade and high yield) and are well above historical

norms at present. Spreads have widened in response to expectations of slower US economic growth, falling asset prices, higher expected default rates and potentially greater issuance supply (municipals in particular). We expect that credit premiums will drop over the next several quarters and that actual annualized losses from defaults will cumulatively be less than the present yield spreads from these sectors reflect. So, we believe, opportunity does exist for significant profit from this point. If you are already invested in this arena, you can comfortably stay.

What then are the implications for us in assisting our clients in implementing debt allocations?

- Use mutual funds for cash-like allocations, avoiding the holding of individual securities.
- For debt allocations, conform fund selections to the expected holding periods, i.e., the longer the holding period, the higher a fund’s duration.
- Obtain broad-based exposures to the debt markets, meaning the selection of a multi-sector fund that is benchmarked to a broad index, such as the Lehman Aggregate Bond Index.
- Look to make allocations to municipals as municipals are very cheaply valued (measured in yield ratios) versus high-grade taxable debt.
- Consider making moderate longer-term allocations to high yield debt (taxable and tax-exempt) over the next several quarters as an opportunistic capture of current credit spreads.

Although markets suffer dislocations from time to time due to credit cycles, markets do adjust and find new price levels as credit risk assessments change and uncertainty is removed to varying degrees. Already, many institutional investment managers and hedge funds have started to buy failed auction ARS paper. Similarly, distressed debt funds and hedge funds have started to make investments in asset-backed debt. This process will continue and greater liquidity will return to distressed sectors of the debt markets. Along the way, bond insurers and underwriters may become more disciplined and investors will better understand that short term debt is not necessarily low risk.

Long Horizon Debt Investing: Deliberately Capitalizing on Credit and Liquidity Risk

In contrast to the problems of *unanticipated* risk described above, we are working on developing an enhanced debt-oriented investment for our clients that will involve an expanded opportunity set and is projected to have bond-like return volatility (e.g., 4% to 5% annualized) in arenas where the risk is perhaps *over*-estimated. We have selected a major institutional bond manager to manage a separate account, available only to our clients at this time, that will be benchmarked off a full maturity (i.e., 1 to 30 years) California municipal index.

This separate account will be managed on an *after-tax, total return* basis. Permissible investments will include non-California municipal bonds, high yield debt, closed-end funds and limited allocations to taxable debt sectors where total after-tax returns are projected to be greater than those for similar duration and credit quality California municipal debt. We believe that accepting risks, such as credit and liquidity, makes sense only if sufficient return compensation is provided to investors over the long term. We believe that alert investors will generally be compensated over full economic cycles for supplying liquidity to certain debt markets. Those of our clients, with allocations to this general asset class, will be paid, we believe, for deliberately accepting credit risk where other market participants mostly avoid such credit exposures.

We expect to introduce this facility near the end of the 2nd Quarter. We will have more to say about this over the next few months.

Rich Palmer

New Conforming Loan Limits

The Economic Stimulus Act of 2008 contained some good news for homeowners in high cost areas. The legislation authorized the Department of Housing and Urban Development to raise the loan limits for mortgages that can be purchased and guaranteed by Fannie Mae and Freddie Mac. The new maximum limit for such loans is \$729,750, a 75% increase over the old maximum limit of \$417,000. The new law also

boosted the limits on loans insured by the Federal Housing Administration (FHA), but it's very unlikely any of our clients will qualify for an FHA loan.

The primary expected benefit of the new limits is lower interest rates on mortgages used for purchasing a new home or refinancing an existing mortgage. In high cost areas like the California coast, homeowners routinely borrow amounts, so-called jumbo loans, much greater than the prior \$417,000 limit. The higher \$729,750 limit should permit more borrowers to finance real estate transactions for their primary residence or second home with conforming loans that are cheaper. Loans backed by Fannie and Freddie *normally* carry interest rates that are between .25% to 1% lower than the rates on loans that are not guaranteed.

However, there are a number of factors at play that may result in a relatively modest benefit to many borrowers when all is said and done. First, the new limits only apply for loans *originated by the end of 2008*. Moreover, many lenders will initially likely apply the new limits only to 30 year or 15 year, fixed rate, fully amortizing loans. Conforming adjustable and interest-only loans (our general preference for our wealthy clients) should come on-line later. Finally, because of the current credit market turmoil, and for other reasons, our banking contacts tell us the interest rate offered by many lenders on so-called conforming jumbo loans—amounts between \$417,000 and the new \$729,750 maximum—may not come down by as much as under traditional arrangements. Consequently, we may see two or more tiers of “conforming” loans with a higher interest rate for conforming jumbo loans. That said, we are seeing some big spreads between conforming and non-conforming 30 year, fixed rate, fully amortizing loans, but the absolute cost of those loans, with their amortization feature, still make them less attractive for many clients.

Lenders are just beginning to roll out programs and pricing for loans to conform to the new limits. The first reports we have received are that pricing is not yet very beneficial, with interest rates higher than expected. But most of the mortgage brokers we talk with expect pricing to improve over the coming months. And the recent action allowing Fannie and Freddie to reduce the amount of capital they must hold as a cushion against losses, while arguably not

prudent banking, should free-up capital to purchase and guarantee more mortgages, which may help lower conforming loan interest rates. By the time you read this, we may know more.

Meanwhile, a few general observations probably still apply:

- Clients with an appetite for indirectly leveraging an investment portfolio should continue to seek the maximum tax-deductible mortgage amount they can obtain, which is a \$1.1 million, *non-conforming* loan. Why? Because unless spreads between conforming and non-conforming jumbo loans become durably much larger than we anticipate, we still think that investment returns produced by indirectly leveraging the larger mortgage will more than compensate for the slightly higher after-tax cost of the debt. (See box below)
- In contrast, for clients with less appetite for leverage and who sleep better with a smaller mortgage who are purchasing a home or refinancing in 2008, could find the new

conforming jumbo loans more appealing.

- In certain circumstance, clients who are no longer actively employed may find it easier... especially in the credit environment of 2008... to get underwritten for a conforming jumbo loan instead of a non-conforming jumbo loan.
- Conforming jumbo loans will have a very limited appeal to clients if, despite expectations to the contrary, lenders only apply the new limit to 30 year or 15 year fixed rate, fully amortized loans.

As noted earlier, there is still much to be learned about how the new limits will impact mortgage options. We plan to write on this topic again after the banks and other mortgage lenders fully roll out their programs. In the meantime, you should call your Kochis Fitz/ Quintile client service team with any questions about how these developments may impact your personal financial situation.

Tom Tracy

Example: 50 bps* rate advantage for conforming over non-conforming.

	\$729,750 "Conforming"	\$1,100,000 "Non-Conforming"
Annual Interest Cost (P/T)		
5.5% conforming	(40,136)	
6.0% non-conforming		(66,000)
Tax Savings @35%	<u>14,048</u>	<u>23,100</u>
After-Tax Cost	(26,088)	(42,900)
After-Tax Return @6.5%	47,434	71,500
Net Investment Return from indirectly leveraged portfolio	\$21,346/yr	\$28,600/yr

This \$7,254 *annual* advantage, multiplied by each separate homeownership taxpayer in the family, can eventually amount to significant additional accumulation potential.

*The higher a durable *rate* advantage for conforming loans, the less the *leverage* advantage for the larger, non-conforming opportunity. Everything else equal, the conforming loan breaks even at a durable 150 bps spread (eg., a 7% rate for a non-conforming when a conforming only costs 5.5%).

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PERFORMANCE RESULTS

			1st Quarter 2008	12 Months to 3/31/08	3 Years Annualized to 3/31/08
Fixed Income	<i>Intermediate</i>	Benchmark Index: Lehman Brothers Aggregate Bond	2.2%	7.7%	5.5%
	<i>(Taxable)</i>	Benchmark Fund: iShares Lehman Aggregate Bond	2.3%	7.6%	5.3%
	*	PIMCO Total Return Institutional	3.3%	10.8%	6.5%
	<i>Intermediate</i>	Benchmark: Morningstar Muni CA Intermediate Category Avg.	-0.1%	1.7%	2.9%
	<i>(Tax Free)</i>	Vanguard CA Insured Intermediate Tax-Exempt Adm	-0.2%	2.1%	3.3%
Real Estate	<i>Global</i>	Benchmark Index: Dow Wilshire Global RESI	-3.2%	-18.6%	14.0%
		Benchmark Fund: 60% SPDR DJ Wilshire Intl RE/ 40% Vanguard REIT Index ETF	-3.2%	-18.3%	N/A
		DWS RREEF Global Real Estate Sec	-6.9%	-18.7%	N/A
	<i>US</i>	Benchmark Index: Dow Jones Wilshire US REIT Index	2.1%	-18.8%	12.0%
		Benchmark Fund: iShares US Real Estate	-0.4%	-20.5%	9.3%
		DWS RREEF US Real Estate	2.0%	-16.6%	12.7%
	<i>Energy Infrastructure</i>	Benchmark Index: Citigroup MLP Index	-7.7%	-10.6%	10.0%
	Kayne Anderson MLP	1.7%	-11.4%	10.6%	
Large Cap: Domestic	<i>Blend</i>	Benchmark Index: S&P 500	-9.4%	-5.1%	5.9%
		Benchmark Fund: iShares S&P 500	-9.4%	-5.1%	5.8%
		Schwab S&P 500 Institutional Select	-9.5%	-5.1%	5.8%
		Schwab 1000 Select	-9.5%	-5.2%	6.2%
	*	Tax Managed Index Separate Account (Aperio)	<i>Return based on individual client's portfolio</i>		
	<i>Value Style</i>	Benchmark Index: Russell 1000 Value	-8.7%	-10.0%	6.0%
		Benchmark Fund: iShares Russell 1000 Value	-8.7%	-10.1%	5.8%
		Berkshire Hathaway B	-5.6%	22.9%	16.1%
	*	DFA Large Cap Value	-7.7%	-12.0%	5.9%
*	DFA Tax Managed Marketwide Value	-9.1%	-12.9%	6.2%	
Large Cap: Developed Overseas	<i>Blend Style</i>	Benchmark Index: MSCI EAFE	-8.8%	-2.3%	13.8%
		Benchmark Fund: Vanguard FTSE All World ex US ETF	-8.6%	2.9%	N/A
		Vanguard Total International Stock Fund	-8.9%	1.3%	15.5%
	<i>Value Style</i>	Benchmark Index: MSCI EAFE Value	-9.6%	-6.8%	12.8%
		Benchmark Fund: iShares MSCI EAFE Value	-9.6%	-7.3%	N/A
	*	DFA International Value	-8.2%	-3.6%	16.0%
*	DFA Tax Managed International Value	-8.4%	-3.5%	16.1%	

* Preferential Access Through Kochis Fitz/Quintile

Returns are stated net of manager's fees, but before Kochis Fitz/Quintile 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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PERFORMANCE RESULTS

			1st Quarter 2008	12 Months to 3/31/08	3 Years Annualized to 3/31/08
Small Cap: Domestic	<i>Blend Style</i>	Benchmark Index: Russell 2000	-9.9%	-13.0%	5.1%
		Benchmark Fund: iShares Russell 2000	-9.9%	-12.9%	5.0%
	*	DFA US Small Cap	-9.6%	-14.1%	4.5%
	*	DFA Tax Managed US Small Cap	-9.7%	-13.7%	4.9%
	*	DFA US Micro Cap	-10.3%	-16.3%	3.7%
	<i>Value Style</i>	Benchmark Index: Russell 2000 Value	-6.5%	-16.9%	4.3%
		Benchmark Fund: iShares Russell 2000 Value	-6.5%	-16.9%	4.1%
	*	DFA US Small Cap Value	-5.9%	-18.5%	4.3%
*	DFA Tax Managed US Targeted Value	-6.5%	-16.8%	4.2%	
Small Cap: Developed Overseas		Benchmark Index: MSCI EAFE Small Cap	-6.2%	-10.9%	11.5%
		Benchmark Fund: SPDR S&P International Small Cap ETF	-6.4%	N/A	N/A
	*	DFA International Small Company	-5.1%	-7.3%	13.3%
	*	DFA International Small Cap Value	-3.7%	-9.1%	13.7%
Emerging Markets		Benchmark Index: MSCI Emerging Markets	-10.9%	21.7%	29.6%
		Benchmark Fund: Vanguard Emerging Markets ETF	-10.4%	21.8%	28.1%
	*	DFA Emerging Markets Core Equity Portfolio (inception date 4/5/05)	-10.2%	17.5%	N/A
		Oppenheimer Developing Markets	-10.0%	18.4%	28.1%
		SSgA Emerging Markets	-12.3%	20.3%	30.1%
	T Rowe Price Emerging Markets	-12.2%	23.8%	31.2%	
Commodities		Benchmark Index: Goldman Sachs Commodity Index	9.9%	38.6%	8.4%
		Benchmark Fund: iShares GSCI Commodity-Indexed Trust	9.7%	37.3%	N/A
		GSCI Enhanced Commodity Total Return Strategy Index ETN	9.4%	N/A	N/A
		iPath GSCI Total Return Index ETN	9.8%	38.0%	N/A
		Oppenheimer Real Asset Y	8.6%	35.5%	8.9%

* Preferential Access Through Kochis Fitz/Quintile

Returns are stated net of manager's fees, but before Kochis Fitz/Quintile 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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