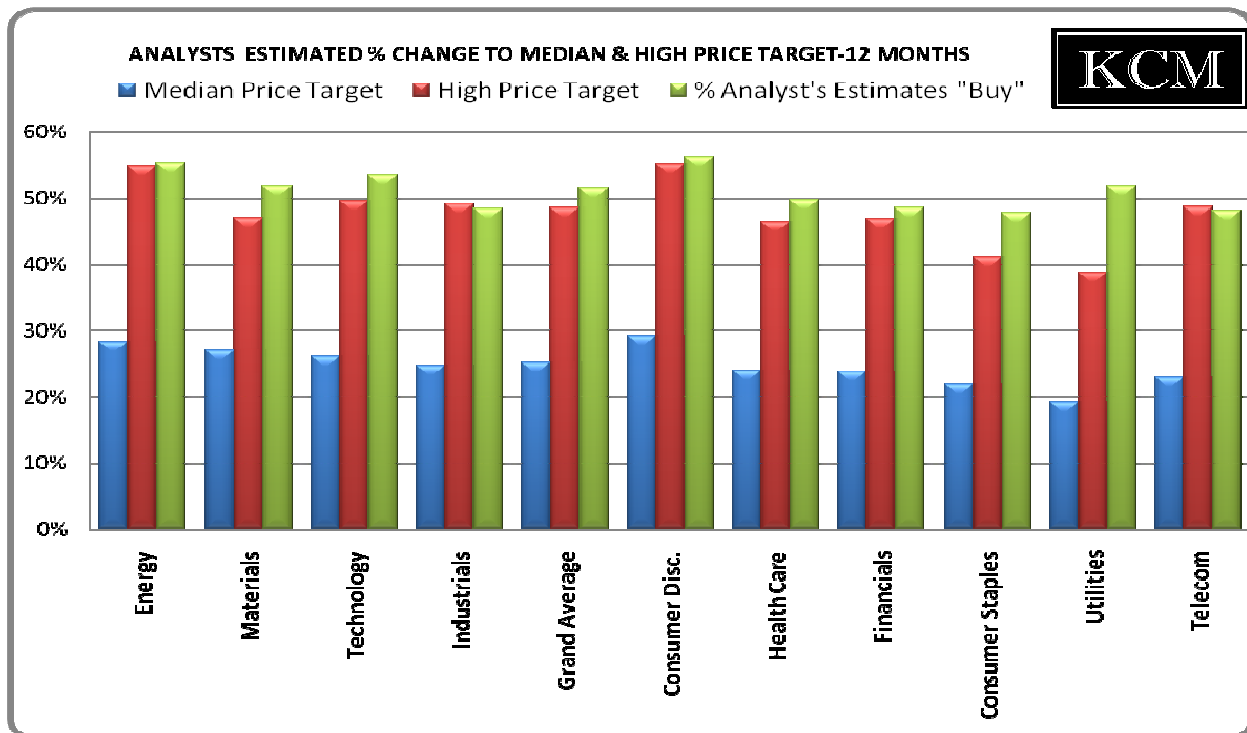


## JUNE 2010 QUARTERLY REVIEW

### ONCE BITTEN BY A SNAKE, HE IS SCARED ALL HIS LIFE AT THE MERE SIGHT OF A ROPE.

Anonymous Chinese Proverb

“The psychology of the stock market couldn’t be worse, yet the valuation probably couldn’t be a whole lot better.” Words muttered by a New York based equity manager that aptly sum up the situation before us as the Second Quarter 2010 limps to a close. With First Quarter earnings having **surged by 53%**, followed by Second Quarter stock prices **plunging nearly 12%**, that is exactly where we sit; confused by a stock market that is trading at 13 times 2010’s projected earnings, 11 times consensus 2011’s earnings with the “Median Wall Street Analyst’s Price Target” for the S&P 500 **up about 25%** (chart below); yet the market feels like it is about to double dip into 2009’s market lows. Interestingly enough, the Second Quarter 2010’s decline was the 12<sup>th</sup> worst quarterly decline since 1950 and greater than the First Quarter of 2009’s decline, which brought the S&P to its lows of “The Great Recession”.



Source: Bloomberg and KCM

The answer to why the bullish earnings outlook cohabits with such negative market sentiment might be found in the human behavior of those suffering from Post-Traumatic Stress Disorder (PTSD). Having been shell shocked by the events of 2008 including the Lehman Brothers bankruptcy, the forced takeover of Bear Stearns and Merrill Lynch, the Government takeover of FNMA and Freddie Mac, the AIG Credit Default swap fiasco, and the resulting near collapse of the economy, investors are going to need a lot of convincing before they are going to be comfortable again with the risks of the stock market. Though the combined efforts of the world’s Central Banks have averted another Great Depression, confidence in the present Administration is at a low and now, two years after the Lehman Brothers collapse, investors are still being treated to regular doses of doomsday forecasts. The deteriorating financial condition of State and Local Governments, the Euro currency crisis, the Southern European financial woes, etc. are all routinely paraded through the media.

We are also seeing the second derivative, the delta of the rate of change to “better”, slow down. This is the opposite of what happened at the March 2009 lows when the rate of change to “worse” slowed down, and the stock market boomed. In the second quarter of 2010, predictions got ahead of reality. Reported data, though generally good, did not meet investor’s expectations.

Surely, we are not Pollyannaish in that real problems do exist. We think these problems are known, manageable, and to a large extent priced into the market. Two-year Treasuries at 0.68% and equities trading at 11.25x forecast earnings is creating a historically attractive value for equities, and a very challenging environment for fixed income investors.

### **Fear Trumps Fundamentals and History**

Let’s look at some previous crises and see how markets behaved:

		1 Month S&P 500 Return	12 Month S&P 500 Return
Mexican Peso/Brazilian Real	December 1994	+ 1.48%	+36.98%
Asian Contagion/Thai Bhat	July 1997	+ 7.23%	+30.97%
Russian Ruble Crisis	August 1998	-14.46%	+20.21%
2010 PIIGS Sovereigns/Euro	June 2010	- 15%	???

The good news is that finally individuals, corporations, municipalities, and central bankers are starting to address their problems. The strong growth we saw in Q1 is moderating, but still positive. Politicians from Athens, Greece, to Athens, Georgia, see the writing on the wall and painful cuts are being made in all segments of labor and services. These austerity and budget cuts will take some wind out of global growth, but it won't lead to a double dip. Corporate balance sheets are in historically great shape with mountains of cash on the sidelines and real strength coming from U.S. manufacturing.

Expectations are for a weaker recovery in 2010 than in past cycles, but three consecutive quarters of positive GDP makes us feel comfortable that this recovery is real. We also note that since WWII, expansions historically have lasted for 5 years.

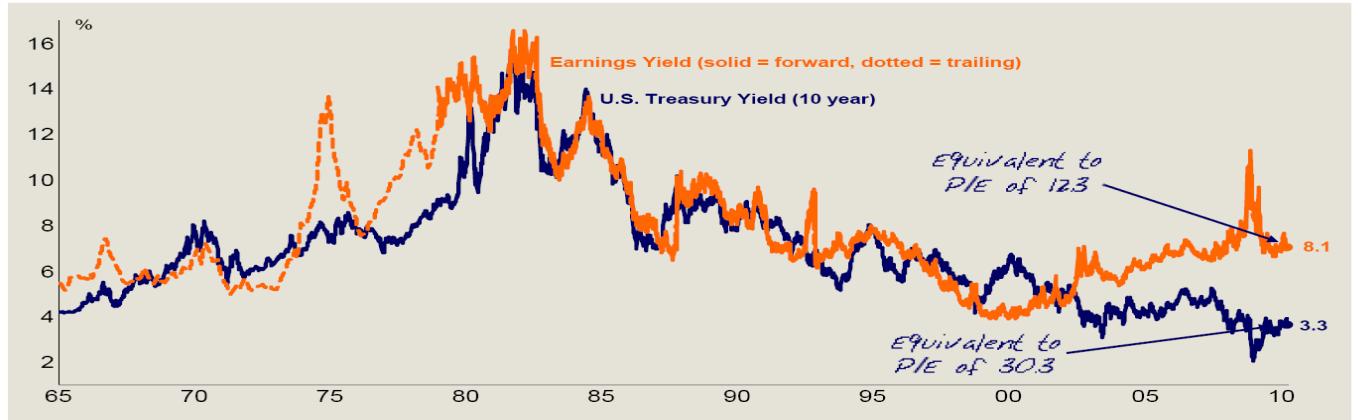
According to Bloomberg, the S&P 500 Index and 10-Year Treasury rates have a correlation coefficient of 0.84, indicating that stock prices and bond yields are the most linked since 1962. We also approached this number at the beginning of the 2002 to 2007 bull market, when U.S. equities doubled.

Other good news includes the ISM Purchasing Managers Report, ISM New Orders Report, German manufacturing and services strength, Spanish bank stabilization, the Chinese economy's apparent "soft landing", and the semiconductor industry's strong book to bill ratio; all positive signs – not just illusions. Recoveries are generally uneven, but the underlying strength of real global activity will prevail.

Saber rattling in North Korea, the BP oil spill, flash crash, financial regulation bills and Thai anti-government riots cannot derail the enormity of the wealth creation coming from China, India and Brazil. We still consider the transition of emerging economies from rural poverty to industrial middle class to be one of the greatest economic movements of all time. The biggest worry is still centered on sovereign contagion, yet the IMF estimates that fiscal austerity packages will only reduce developed countries' GDP growth by 0.50% and total global GDP growth by 0.25%.

The economy is growing, but domestically we've come to a point where investors are saying "show me" before they are willing to commit new capital. There is no doubt that the economy is expanding, yet financial markets are waiting to see more evidence that we are moving from recovery to sustainable expansion. Once it arrives, the equity markets and the 10 Year Treasury yield should both be significantly higher.

### Stock vs. Bond Valuation



Stocks look cheap compared to bonds using the “Fed Model”, which compares the yield-to-maturity on U.S. Treasury bonds to the earnings yield (E/P) of stocks.

Source: ING

We observe that the P/E ratio for the highest quality companies is about on par with that of the lowest quartile companies. We can now buy higher quality, dividend paying, stable-growth companies with strong franchises, high barriers to entry, low earnings risk and strong balance sheets at the same valuations as lower-quality, more cyclical names. This is a rare occurrence. In light of the magnitude of last year’s “junk rally”, we believe the stage is set for a strong rotation toward blue-chip stocks.

We have a positive outlook for stocks, but we don’t believe the S&P will meet the median Wall Street price target of up 25% over the next 12 months, nor do we believe the economy will “double dip”. We think stocks are fairly priced and expect mid to high single digit returns over the next twelve months.

### Credit Markets

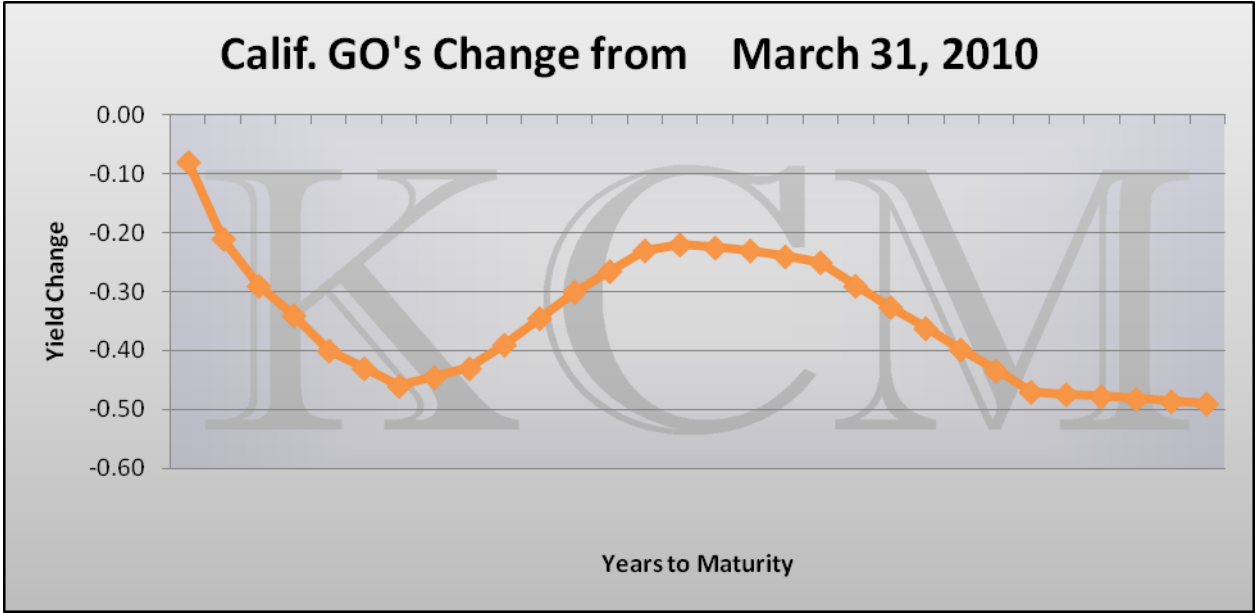
Market angst, fear over the sovereign debt in Southern Europe, even in the wake of the 750 billion euro rescue package, has triggered a flight to short duration US Treasuries, gold, and overnight deposits, which essentially yield zero. These extremely low yields are keeping KCM unusually cautious. For the most part, we are concentrating our bond investments in short maturities of higher quality names, keeping our “powder” dry without reaching for yield.

One has only to look back at recent history to understand why KCM has adopted this stance. In 1999, at the height of greed in equity markets, investors plowed \$190 billion into equity mutual funds compared to \$5.5 billion in bond

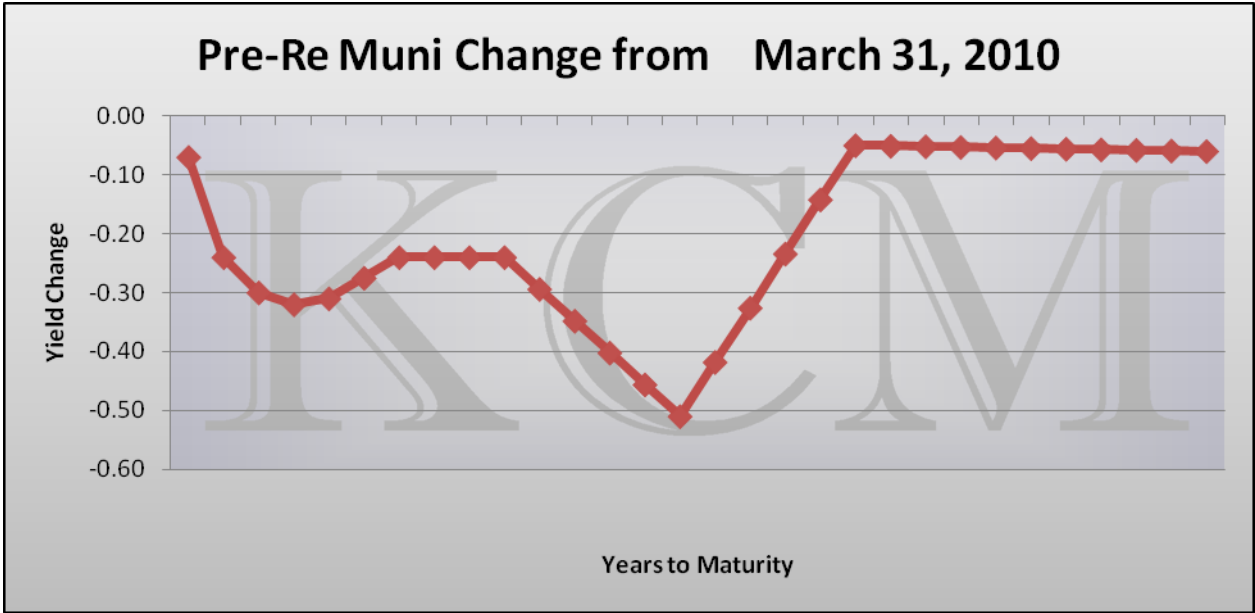
funds. Last year mutual fund investors plowed \$375 billion in bond funds with historic low yields and invested just \$11.3 billion in equity funds. We think it somewhat obvious where this might lead.

Yield Curves 6-30-10					
YEARS	California General Obligation Tax-Free (GO's)	National Pre-Refunded Muni	Corporate "A" Rated	California Build America Bonds (BAB's)	Treasury Bonds
1-2011	0.80	0.32	0.92	1.89	0.34
2-2012	1.21	0.58	1.20	2.27	0.63
3-2013	1.66	0.94	1.78	3.30	1.00
4-2014	2.16	1.33	2.39	3.76	1.44
5-2015	2.64	1.71	2.63	4.05	1.80
6-2016	3.05	2.03	3.02	4.46	2.12
7-2017	3.46	2.35	3.41	4.86	2.44
8-2018	3.76	2.55	3.62	5.01	2.61
9-2019	4.06	2.74	3.83	5.16	2.79
10-2020	4.28	2.94	4.04	5.37	2.96
11-2021	4.43	3.06	4.15	5.58	3.09
12-2022	4.58	3.18	4.26	5.79	3.23
13-2023	4.68	3.31	4.36	5.88	3.36
14-2024	4.77	3.43	4.47	5.98	3.49
15-2025	4.85	3.55	4.58	6.07	3.63
16-2026	4.92	3.64	4.65	6.16	3.66
17-2027	4.98	3.73	4.71	6.25	3.69
18-2028	5.03	3.81	4.78	6.34	3.72
19-2029	5.08	3.90	4.85	6.44	3.75
20-2030	5.13	3.99	4.92	6.53	3.78
21-2031	5.15	4.01	4.93	6.62	3.79
22-2032	5.16	4.03	4.95	6.71	3.81
23-2033	5.18	4.04	4.96	6.80	3.82
24-2034	5.19	4.06	4.98	6.90	3.83
25-2035	5.21	4.08	4.99	6.84	3.84
26-2036	5.21	4.10	5.01	6.78	3.86
27-2037	5.22	4.12	5.02	6.78	3.87
28-2038	5.22	4.13	5.04	6.78	3.88
29-2039	5.23	4.15	5.05	6.78	3.89
30-2040	5.23	4.17	5.07	6.78	3.91

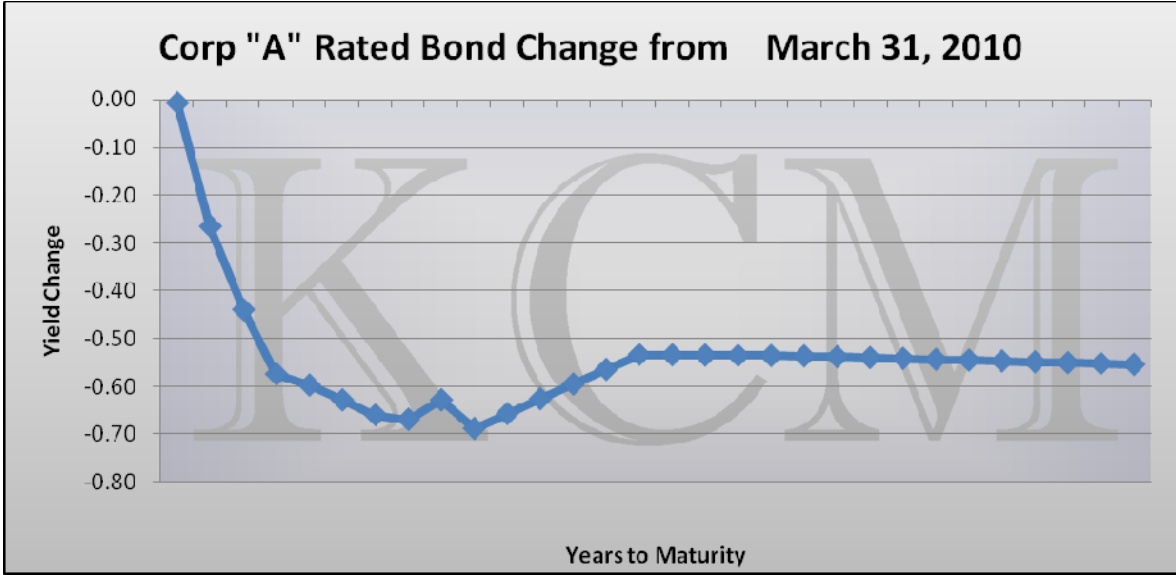
We continue to find value in California General Obligation Tax-Free and Taxable bonds (BAB's). It is difficult to find value on the Corporate or Treasury curve.



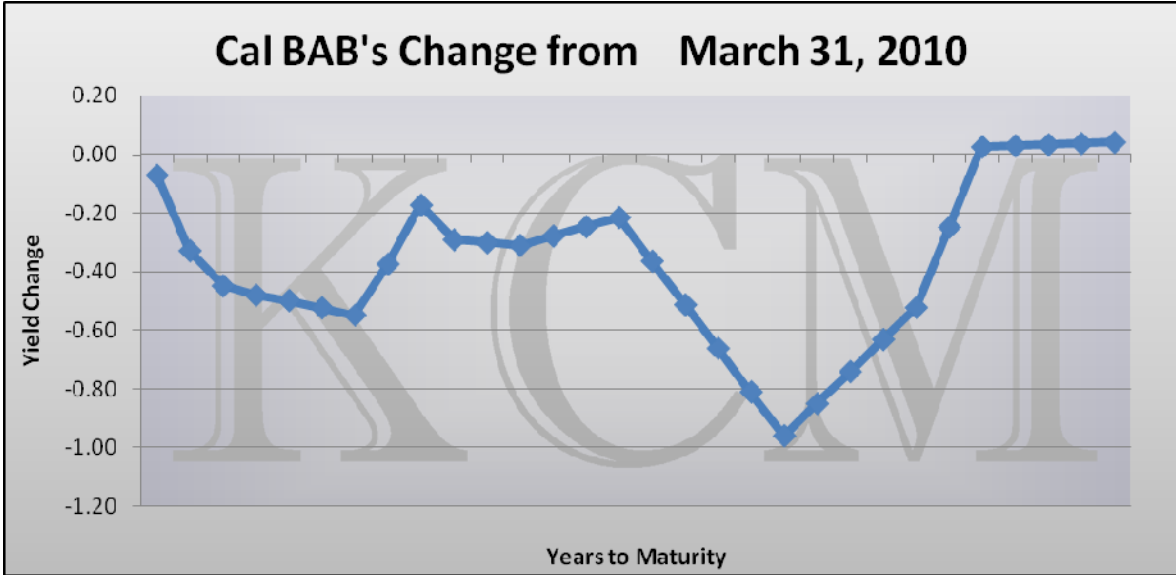
California General Obligation Tax-Free bonds performed well during the quarter, going down in yield as much as 50 basis points at the longer end of the curve. Despite California’s headline financial problems, investors remained comfortable with the General Obligation credit.



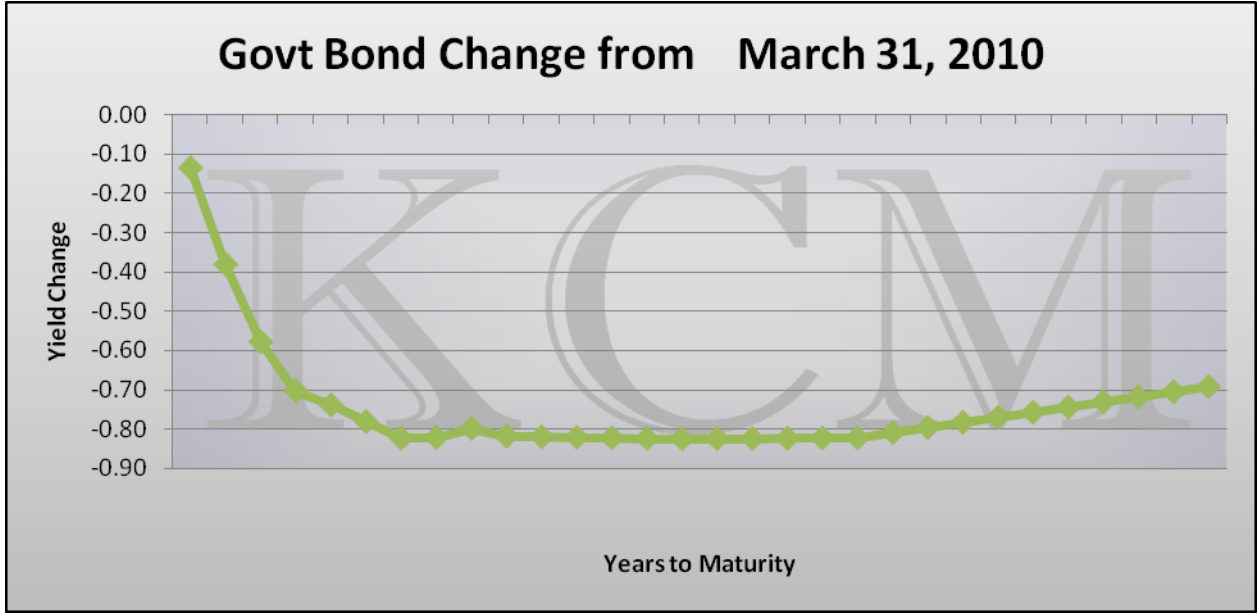
Pre-Refunded bonds (essentially tax-free Treasuries) also performed well during the quarter, reflecting a general flight to quality. They have become difficult to buy and very expensive.



The stretch for yield pushed corporate bond yields lower.



The very popular Build America Bond program (about 1/3 of municipal issuance) also performed well during the quarter. We were told that about 30% of the last California BAB deal was sold overseas!



The above chart shows that the flight to quality trade still means buying U.S. Treasury bonds. The fact that Treasury bonds continue to rally (go down in yield) also reflects skepticism about the strength of the recovery.

We look forward with optimism to serving you in the quarters and years ahead.

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