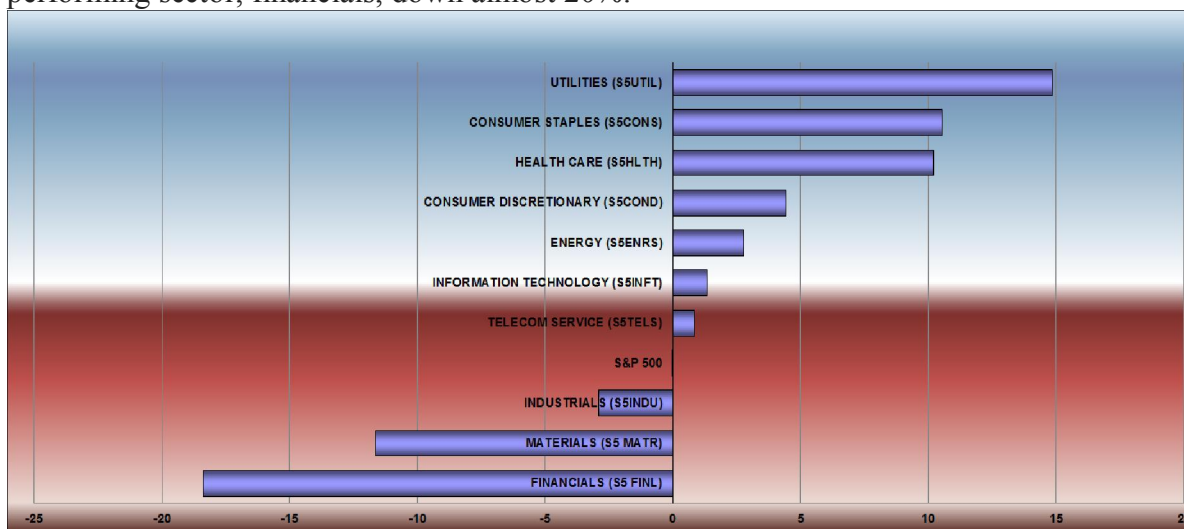




DECEMBER 2011 QUARTERLY COMMENTARY

THE UNITED STATES, THE SAFEST HARBOR?

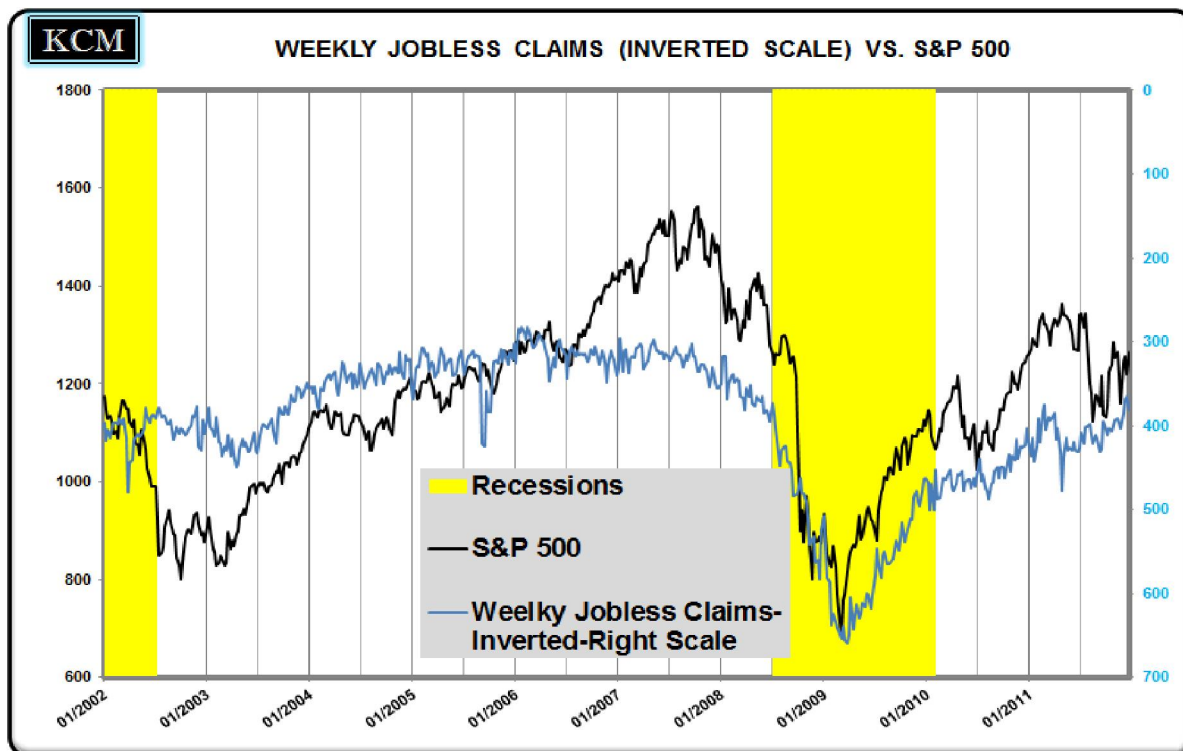
We ended 2011 with an essentially flat U.S. stock market, the S&P 500 was up about 2%, **all** of which came from dividends, and the index price was almost exactly the same, 1257.60 vs. 1257.64. There was, however, a wide variation in sector performance. The best performing sectors for the year were the traditionally defensive sectors — utilities, consumer staples and health care — which also have, in general, the highest yields. The laggards were financials and materials. The best performing sectors were up 10%-15% and the worst performing sector, financials, down almost 20%.



Bloomberg & KCM - December 31, 2010 to December 31, 2011

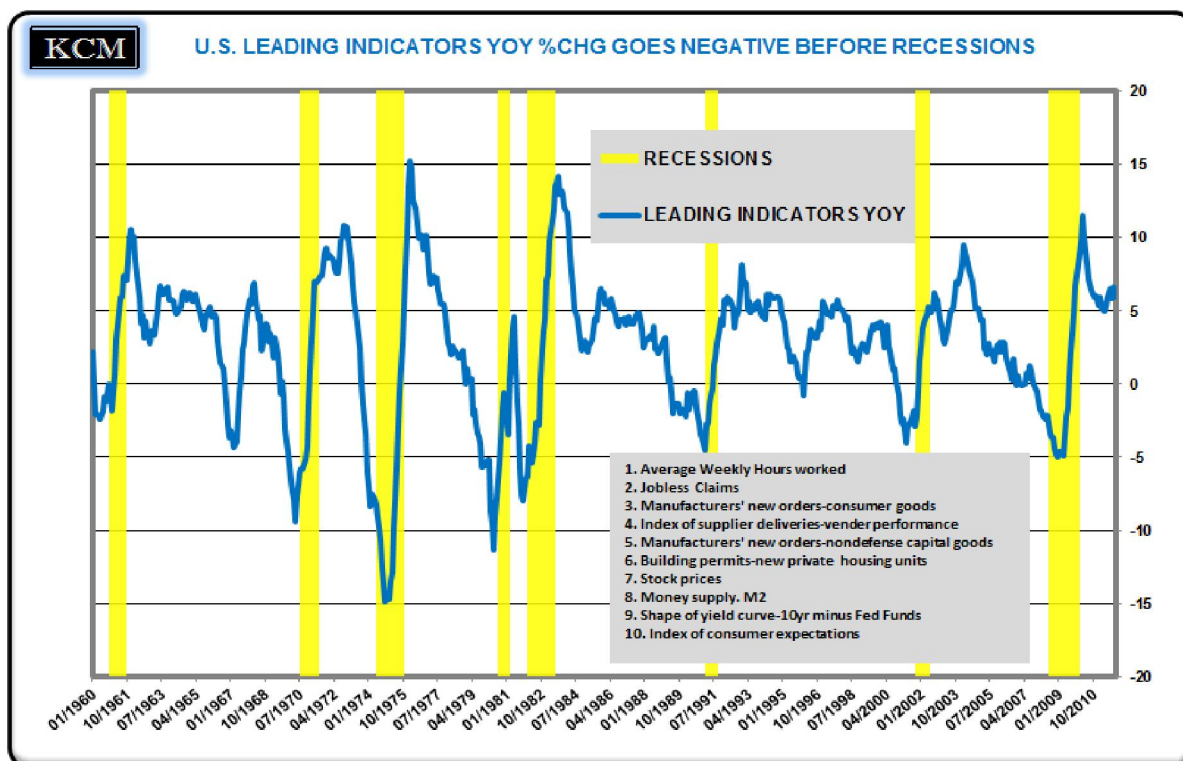
Despite being lackluster, the U.S. stock market had an outstanding year relative to the rest of the developed and emerging markets. Europe, China, Canada and Japan were down 15%-20%, Latin America and emerging markets down 15%-30%. Most of the world's markets bottomed at the end of the third quarter and then had a bounce in October, ending the fourth quarter up 5%-10% (Japan was down 2.5% for the quarter).

The economic trends in the fourth quarter were pretty much the same as during the year. U.S. data continued to improve while the Eurozone slipped into a recession. Some of the improving U.S. economic data at quarter-end included construction spending (up), ISM manufacturing and non-manufacturing (up), auto sales (up), unemployment rate (down), consumer credit (up), credit card delinquencies (down), housing starts (up), building permits (up) and pending home sales (up), initial and continuing jobless claims (down), consumer confidence (up), and leading indicators (up). The opposite happened in the Eurozone. As an example, the overall ZEW, Eurozone expectation of economic growth, slipped to -54.1 from a 2009 high of +60.



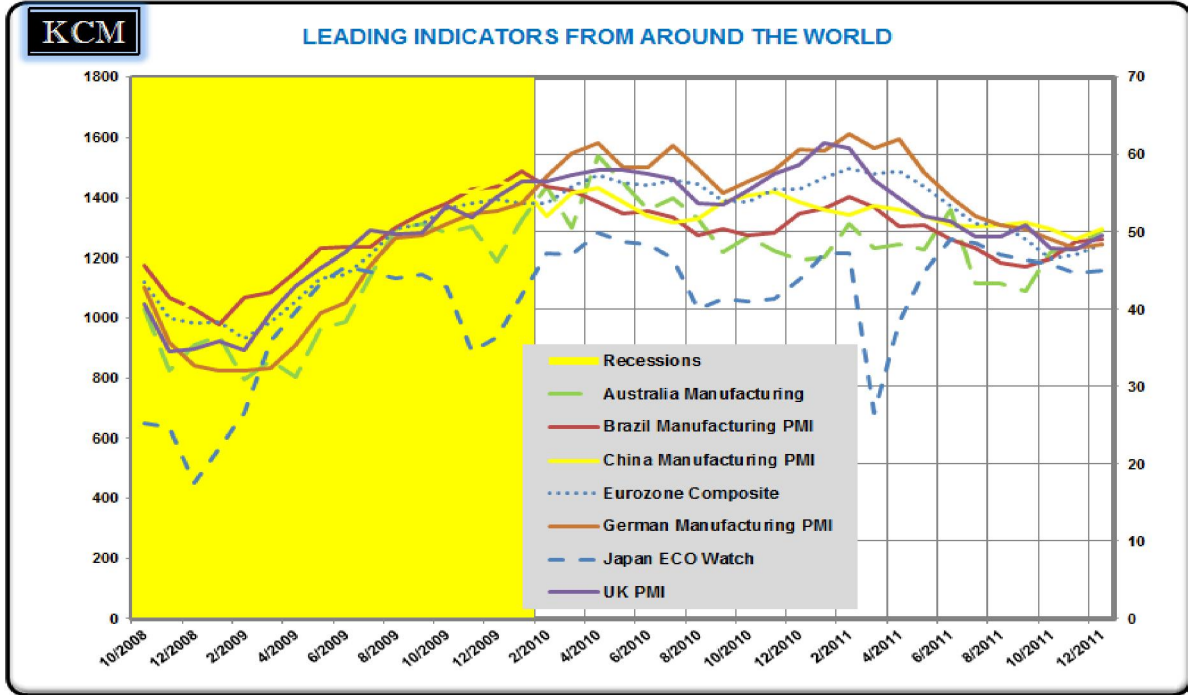
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Jobless claims were at a recovery low of 372k vs about 650k at the recession bottom. There is a good correlation between the jobless claims trend and the S&P 500.



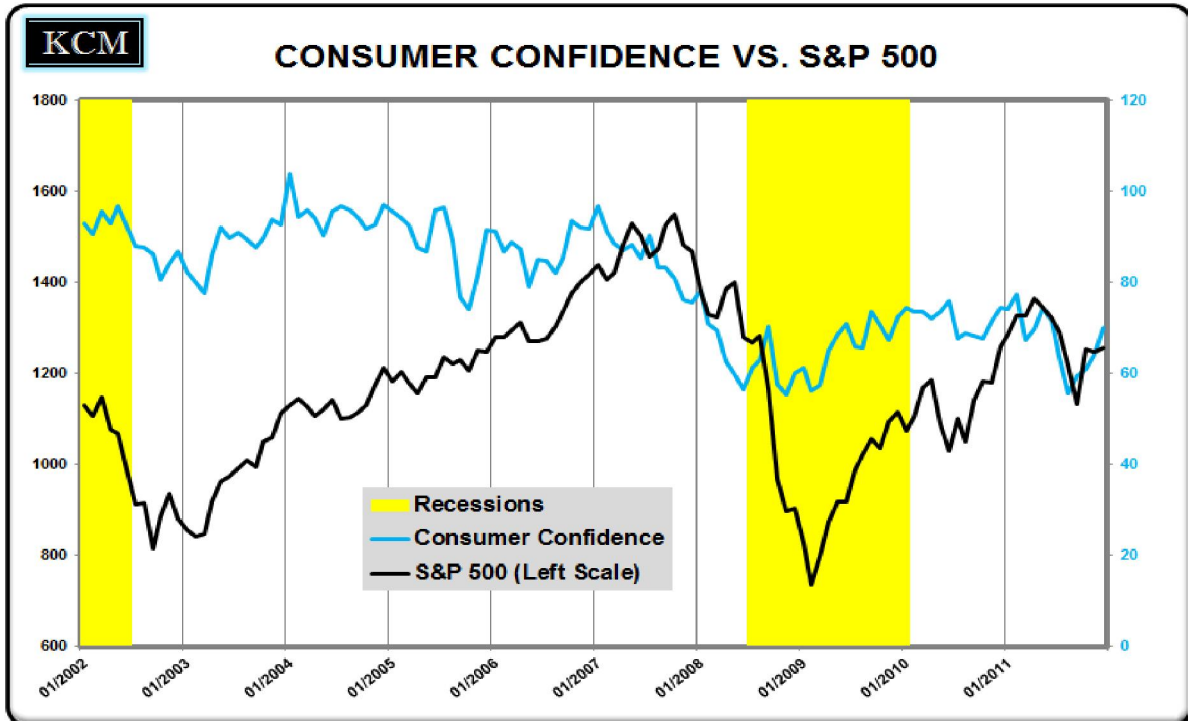
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U.S. leading indicators were up year-over-year...



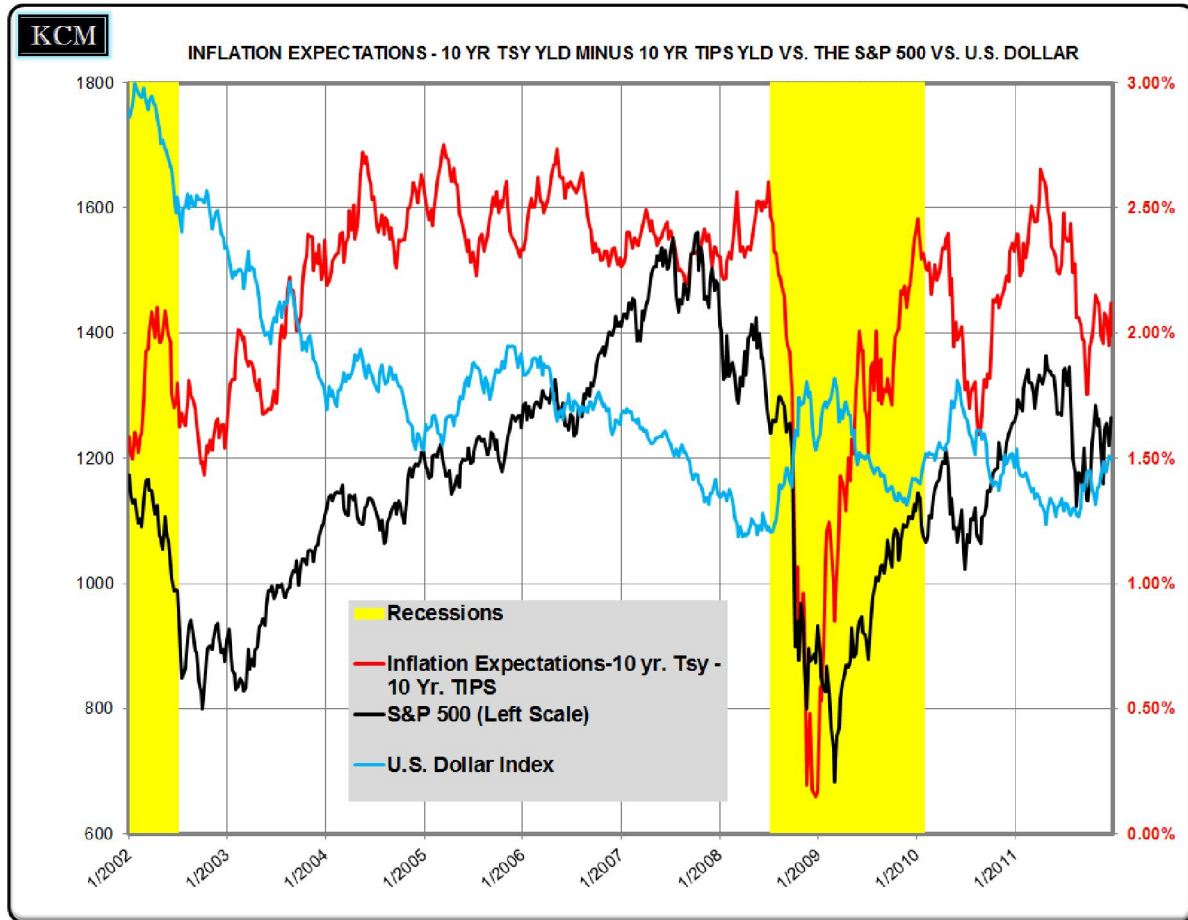
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...while the leading indicators from around the world continued their downward bias, most ending the year below “50,” indicating their economies may be contracting. (We also note that most were up, month-over-month, in December.)



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Consumer confidence improved during the fourth quarter, another potentially good leading indicator for the U.S. stock market.



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Inflation accelerated around the world in 2011, but inflation expectations actually declined from a high of about 2.6% to 2.2% at year-end. The U.S. Dollar Index and the S&P ended the year about where they started. We believe that deflationary pressures around the world will keep U.S. inflation and inflation expectations in check in 2012, which should support consumer confidence and spending. Specifically, stable or lower energy costs (especially natural gas!), a recession and a bank crisis in the Eurozone, fiscal tightening and labor reforms everywhere, potentially 0% GDP growth in Japan, and an aging population in the developed economies will all be deflationary trends (a potential negative for equity valuations). Also, the declining price of gold may signal that the dollar is stable and inflation is under control for now.

The New Year started with a series of better-than-expected U.S. economic numbers and a low probability of a double-dip U.S. recession. Other mature and emerging economies are probably entering a recession (Eurozone) or are slowing (China, Japan and Brazil). Inflation and inflation expectations in the U.S. are muted. Much of our outlook will depend on tough-to-forecast macro outcomes, including the resolution of the European debt crisis, our own U.S. deleveraging and credit problems, Eurozone and emerging market growth (China and India will produce about half of the world's growth), our upcoming elections, fiscal and monetary policy around the world, and unpredictable outcomes to social disruptions like Occupy Wall Street. If our base case is correct, we believe that the United States and, in particular, large cap, dividend paying U.S. stocks will be the safest harbor.

FIXED INCOME

| KCM | Change Between 12/31/10 and 12/30/11 Yield Curves | | | | Start 12/31/10 +360 Days | Start 12/31/10 +360 Days | Start 12/31/10 +360 Days | Start 12/31/10 +360 Days |
|---------|------------------------------------------------------|-------------|-------------|----------------|-----------------------------|----------------------------------------------------|-------------------------------------------------|-------------------------------------------------------|
| | YEARS | Calif. GO's | Nat.AA Muni | Corp "A" Rated | T Bonds | Calif. GO's Change from December 31, 2010 | Nat.AA Muni Change from December 31, 2010 | Corp "A" Rated Change from December 31, 2010 |
| 1-2013 | 0.52 | 0.44 | 0.78 | 0.13 | -0.83 | -0.45 | 0.03 | -0.14 |
| 2-2014 | 0.83 | 0.65 | 0.92 | 0.28 | -0.95 | -0.59 | -0.19 | -0.32 |
| 3-2015 | 1.08 | 0.93 | 1.14 | 0.38 | -1.16 | -0.66 | -0.59 | -0.65 |
| 4-2016 | 1.32 | 1.13 | 1.52 | 0.60 | -1.34 | -0.82 | -0.90 | -0.91 |
| 5-2017 | 1.58 | 1.27 | 1.88 | 0.85 | -1.47 | -1.06 | -0.87 | -1.16 |
| 6-2018 | 1.89 | 1.47 | 2.22 | 1.11 | -1.53 | -1.23 | -0.93 | -1.26 |
| 7-2019 | 2.20 | 1.66 | 2.57 | 1.37 | -1.59 | -1.39 | -0.99 | -1.35 |
| 8-2020 | 2.54 | 1.91 | 2.80 | 1.56 | -1.54 | -1.43 | -1.04 | -1.38 |
| 9-2021 | 2.88 | 2.17 | 3.02 | 1.76 | -1.48 | -1.47 | -1.04 | -1.37 |
| 10-2022 | 3.21 | 2.42 | 3.25 | 1.96 | -1.38 | -1.51 | -1.12 | -1.42 |
| 11-2023 | 3.49 | 2.66 | 3.37 | 2.07 | -1.27 | -1.43 | -1.14 | -1.45 |
| 12-2024 | 3.77 | 2.90 | 3.49 | 2.18 | -1.16 | -1.34 | -1.15 | -1.47 |
| 13-2025 | 3.98 | 3.15 | 3.61 | 2.30 | -1.07 | -1.26 | -1.16 | -1.49 |
| 14-2026 | 4.18 | 3.39 | 3.73 | 2.41 | -0.98 | -1.17 | -1.17 | -1.51 |
| 15-2027 | 4.32 | 3.63 | 3.85 | 2.53 | -0.94 | -1.09 | -1.18 | -1.53 |
| 16-2028 | 4.41 | 3.72 | 3.89 | 2.56 | -0.94 | -1.09 | -1.19 | -1.53 |
| 17-2029 | 4.50 | 3.80 | 3.94 | 2.59 | 0.93 | -1.10 | -1.20 | -1.52 |
| 18-2030 | 4.56 | 3.89 | 3.98 | 2.62 | -0.95 | -1.10 | -1.22 | -1.51 |
| 19-2031 | 4.61 | 3.97 | 4.03 | 2.65 | -0.97 | -1.11 | -1.23 | -1.50 |
| 20-2032 | 4.66 | 4.06 | 4.07 | 2.69 | -0.96 | -1.11 | -1.24 | -1.50 |
| 21-2033 | 4.71 | 4.10 | 4.09 | 2.71 | -0.94 | -1.09 | -1.24 | -1.49 |
| 22-2034 | 4.76 | 4.14 | 4.10 | 2.73 | -0.93 | -1.06 | -1.23 | -1.48 |
| 23-2035 | 4.80 | 4.18 | 4.12 | 2.75 | -0.91 | -1.04 | -1.23 | -1.47 |
| 24-2036 | 4.85 | 4.22 | 4.14 | 2.78 | -0.90 | -1.01 | -1.22 | -1.46 |
| 25-2037 | 4.90 | 4.27 | 4.15 | 2.80 | -0.88 | -0.99 | -1.22 | -1.45 |
| 26-2038 | 4.90 | 4.31 | 4.17 | 2.82 | -0.90 | -0.97 | -1.21 | -1.45 |
| 27-2039 | 4.90 | 4.35 | 4.18 | 2.85 | -0.93 | -0.94 | -1.20 | -1.44 |
| 28-2040 | 4.91 | 4.39 | 4.20 | 2.87 | -0.95 | -0.92 | -1.20 | -1.43 |
| 29-2041 | 4.91 | 4.43 | 4.21 | 2.89 | -0.98 | -0.89 | -1.19 | -1.42 |
| 30-2042 | 4.91 | 4.47 | 4.23 | 2.91 | -1.00 | -0.87 | -1.19 | -1.41 |

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Yields on most fixed income classes ended the year at or near their 12-month lows and fixed income securities produced some of the best returns in 2011.

Longer-term U.S. treasury bonds declined in yield as much as 150 basis points as investors sought a safe haven from the financial crisis in Europe.

“A” rated corporate bond yields also declined about 120 basis points in the longer maturities

“Muni Bonds: A Disaster That Wasn’t” was a December 23rd headline in the *Wall Street Journal*. The article went on to point out that municipal bonds “wound up being a contrarian bet that paid off big in 2011.” Well, for KCM clients, municipal bonds were not a “contrarian bet.” To quote from our December 2010 quarterly: “We find the recent pickup in yield (lower prices) has created a compelling opportunity for our high net worth clients. Jitters for select municipal credits have created unique opportunities for high net worth investors that we do not think will persist. Some quality municipals are on sale!”

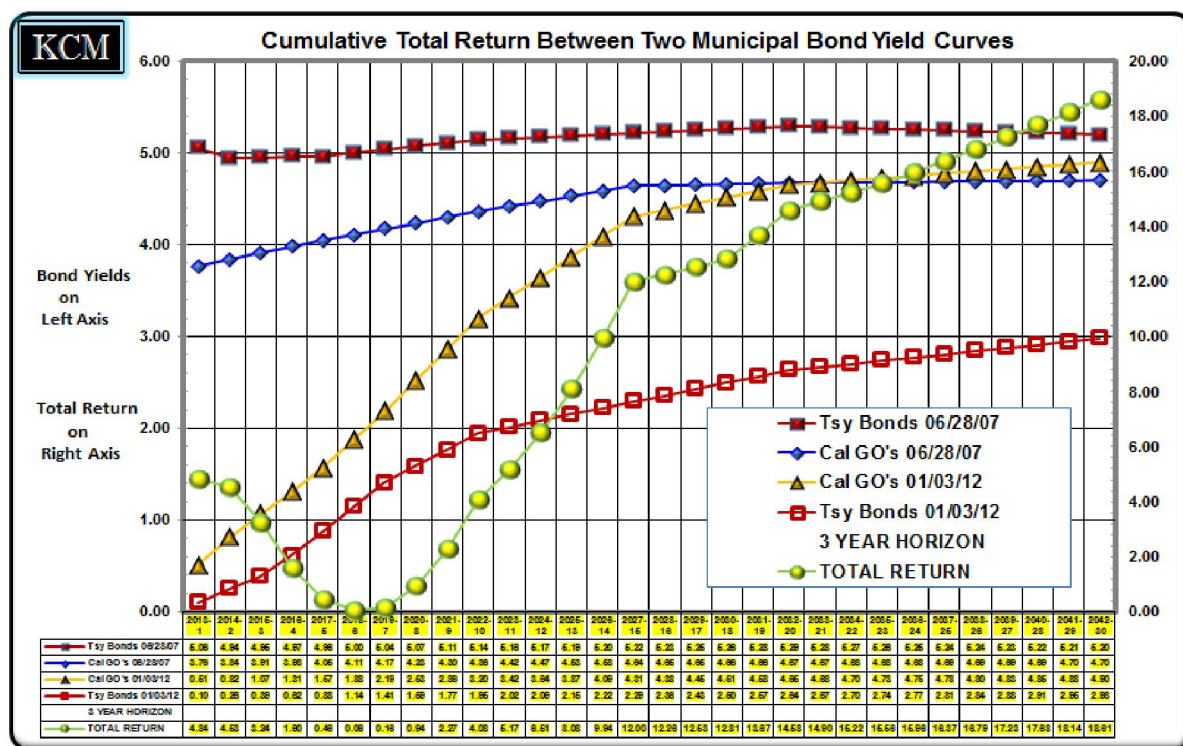
California general obligation bonds, despite the dire predictions of some analysts, turned out to be one of the best performing securities in the world.

Great ... we were right, now what?

The Federal Reserve has told us that it will keep short-term interest rates very low until at least mid-2013. The European Central Bank has initiated a 500 billion euro three-year,

guaranteed low interest rate, financing program (LTRO) and some members of the Fed have called for language that would extend their low interest rate guarantee past 2013 or until inflation becomes a problem or specific unemployment goals are met. Our first conclusion is that it is safe to own fixed income securities of most any duration for the next two to four years. Our favorite fixed income investment remains select municipal bonds with 15- to 20-year maturities (chart below).

The obvious object of a sustained low interest rate environment is to stimulate the economy and specifically to support the still moribund housing market. The unintended consequences of sustained low interest rates, and negative “real” interest rates, are an environment that will eventually create excessive inflation. Inflation, measured by the core CPI, peaked at about 3% in late 2006, and you have to go back to 1993 to find a higher year-over-year number. If the economy and the inflation look like they did at the peak of the last recovery, select 15- to 20-year municipal bonds still look attractive.

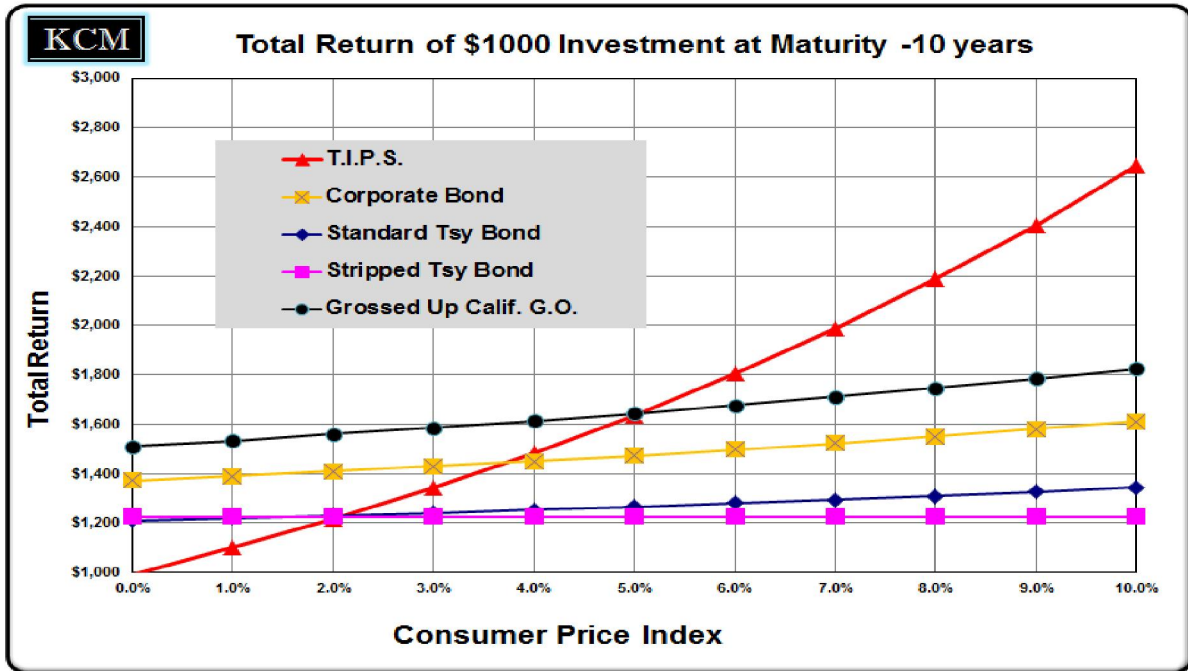


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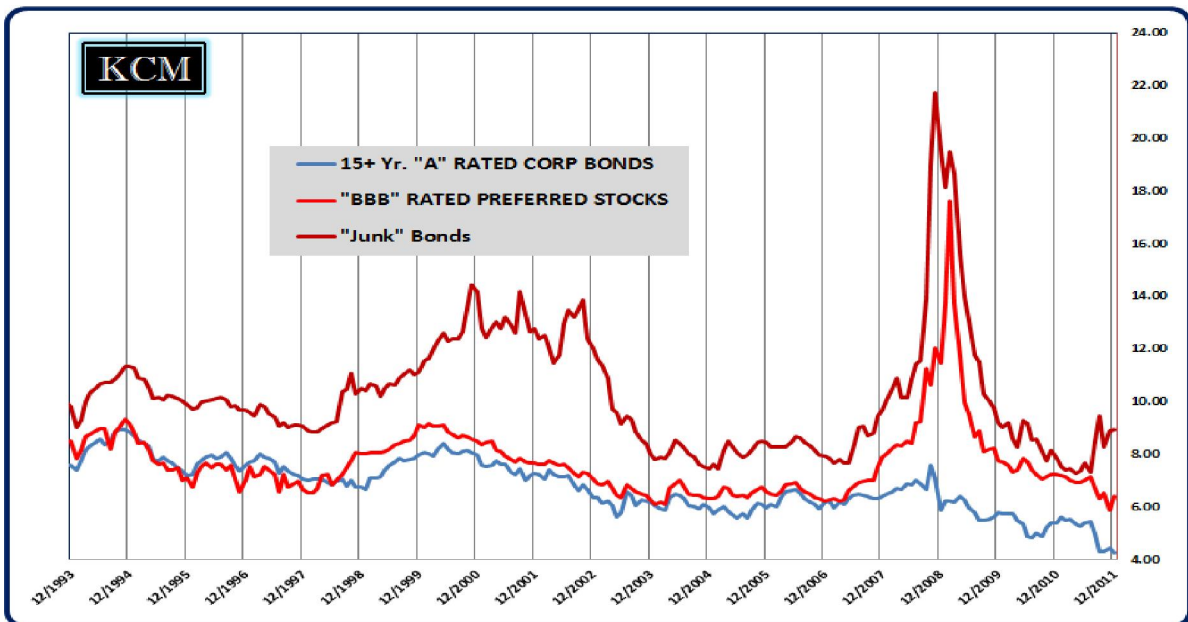
Still, to hedge your bets and guard against excessive inflation, some portion of a fixed income portfolio should be relatively short. Yield curves are “steep” so you will get some “curve roll” buying two- to four-year maturities. A barbell approach allows you to take advantage of an extended period of low rates and at the same time protect some of your principal.

Some have suggested that a good way to protect a portfolio from inflation is to buy TIPS, Treasury inflation protected securities. We disagree. The year-over-year CPI is about 2.2%, the same as the market’s inflationary expectations as measured by the previous inflation expectation chart (page 4) and the break-even point between 10-year nominal Treasury bond yields and 10-year TIPS as illustrated in the following chart. This chart also shows us that

the break-even for a 10-year corporate bond is just under 4%, and, in a taxable account, the break-even for a 10-year California general obligation municipal bond is 5%. This means that inflation must AVERAGE more than 4% or 5% for the next 10 years for TIPS to outperform corporate or municipal bonds. Starting in the spring of 1966, with CPI about where it is today, inflation averaged about 5% for the next 10 years. We also had an 11-year period between 1972 and 1983 when inflation averaged about 8%. So, it is certainly possible that inflation becomes a problem down the road, but it has to happen fairly soon and it has to AVERAGE over 5% for the next 10 years for TIPS to be attractive versus a 10-year California municipal bond.



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We also like preferred stocks for a portion of a portfolio. Selective preferred stocks still have an unusually wide spread to comparable quality corporate bonds, giving you some protection in a rising interest rate environment and a very attractive yield in the low interest rate environment we are likely to continue to have for the next few years.

SUMMARY

The message is still mixed and some of the world's economies are at a tipping point, but there are enough positive trends in the United States that we encourage you to have some exposure to the equity markets and watch for an opportunity to overweight that asset class, with a **focus on large capitalization U.S. corporations that have solid balance sheets and pay fat, secure dividends.**

Inflation is muted and interest rates are likely to remain low for some time, but aggressive fiscal and monetary stimulus may eventually cause excessive inflation, so invest a portion of your fixed income portfolio with this possibility in mind.

Policy makers are in control and their ability to cooperate and solve the problems that are straining the global financial markets will dictate which direction the world economies and markets tip. This is especially true for European policy makers and their response to the EU's sovereign debt crisis. A disorderly end to the EU's problems would almost certainly cause a global recession.

We wish all our clients, associates and partners a healthy and happy New Year. We thank you for your continued support and confidence and we look forward to serving you in the quarters and years ahead.

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