Happy New Year, Indeed!

Investors had plenty to cheer about as they rang in 2011, having reaped fairly attractive returns in both the equity and fixed income markets in 2010. For those more heavily weighted toward the riskier elements of these markets, December was particularly rewarding as that month alone contributed a significant portion of the year's overall gains. The essential ingredient to the happy ending to 2010 seemed to be a recognition that the recovery, while not threatening to outshine any of recent memory, may prove more durable than suspected earlier in 2010 and should accelerate nicely into the New Year.

The Federal Reserve is doing its part by keeping its foot firmly on the accelerator. Its widely advertised and generally maligned second effort at quantitative easing did little to keep interest rates down but the liquidity it provided, along with higher interest rates, appeared to help steer investors in the direction of the equity markets. The President and a lame-duck Congress added some additional fuel to the fire by agreeing to extend the 2002 tax cuts another two years and unemployment benefits another 13 months. And in the hope of spurring job growth, they agreed on another stimulus package in the form of a temporary 2% reduction in the payroll tax and the ability of businesses to expense for tax purposes capital investments in 2011.

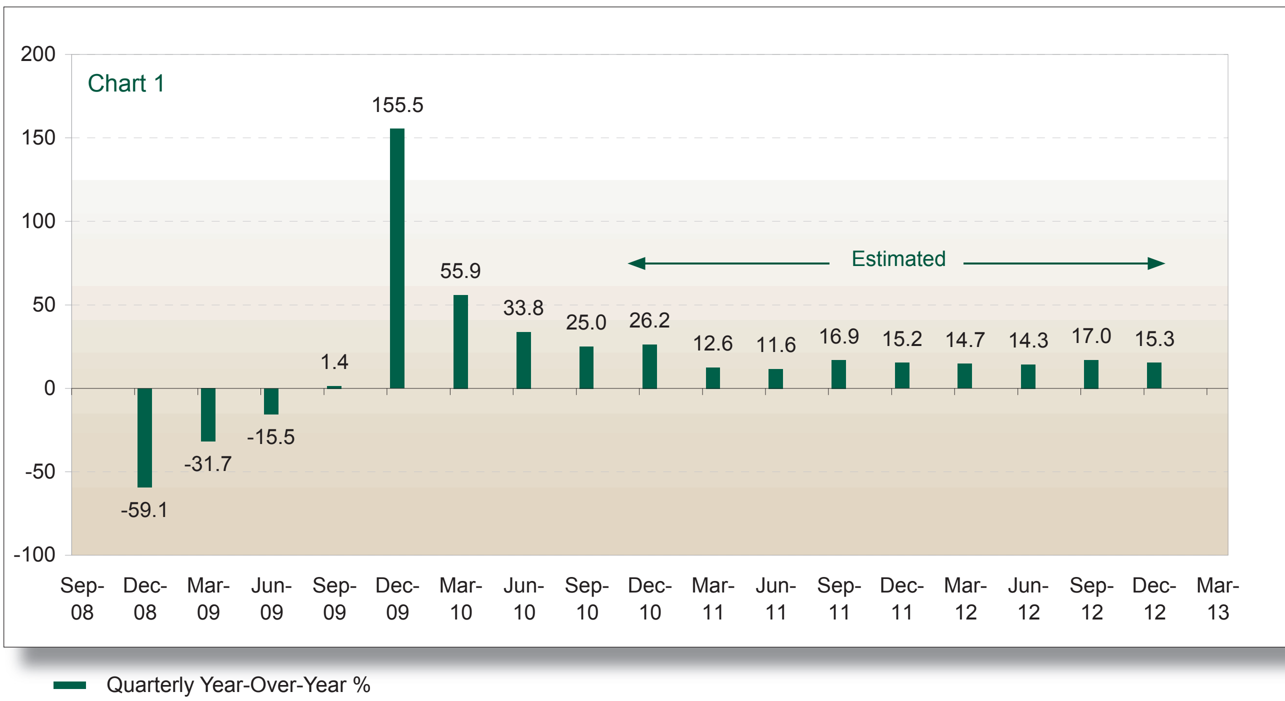
And though we point to these developments as a reason for the strong gains in equity prices in December, it is just as valid to point to the recovery in stock prices over the second half of 2010, which added over $2 trillion in market value, as one of the factors driving the improvement in the economic outlook. In addition to capping off a rewarding, if not entirely smooth, 2010 the recent results have put equity indices much closer to the highs of October 2007 that preceded the slide into the Great Recession and financial crisis of 2008 and 2009. On a total return basis, encompassing both dividends and their reinvestment, we finished 2010 about 13.6% below that October high as measured by the S&P 500 index.

The details of results from the various sectors of the capital markets through the end of 2010 are shown in the Total Return Summary on the Exhibits page of this report. True to form, the strong results of 2010 reflected a willingness of investors to assume risk as evidenced by the relative outperformance of small and medium companies, emerging markets and high yield debt. A stronger dollar over the course of the year offset gains in developed international markets upon translation into U.S. dollar-based results. The sharp increase in interest rates in the third quarter pared the returns from investment-grade fixed income securities for the year to only a modest improvement over the coupon yield.

Expectations for 2011 and Beyond

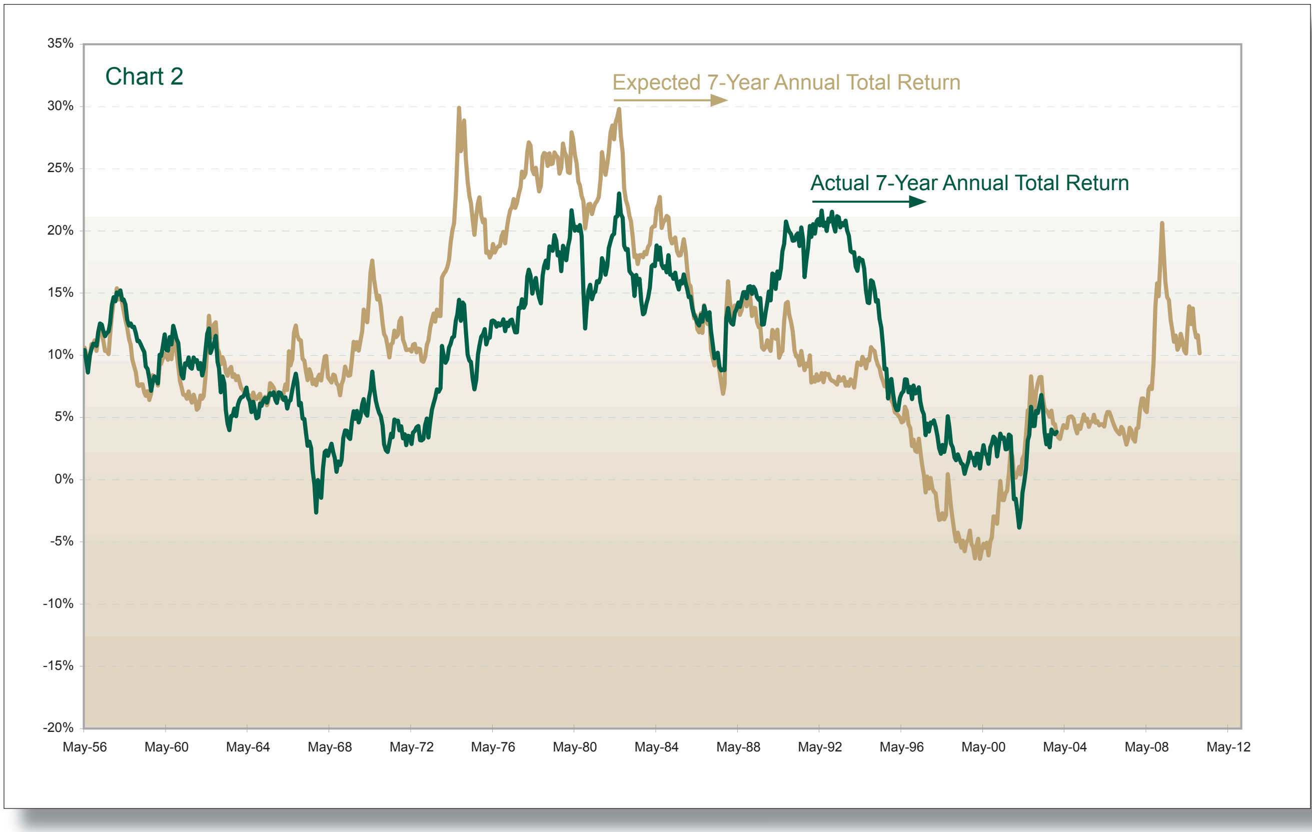
Parsing results further, we observe that the year's total return for the S&P 500 index of about 15% derived from an increase of about 29% in profits through the third quarter, a reduction of about 13% in valuation (the price-to-earnings ratio) and a dividend yield of just over 2%. Looking into 2011, we would expect profit growth to moderate following what should be very good gains in fourth quarter results. For the year we expect to see a total return for the S&P 500 that is more consistent with the gain in profits now that valuation has returned to the middle of its historical range. Ample liquidity, somewhat higher interest rates, the support of new stimulus measures and an increase in profits of 12% to 15% over the next 12 months (Chart 1) should support average returns from stocks in 2011. Improvement in sentiment from such factors as improved job growth and merger and acquisition activity would likely add to total return through improved valuation.

S&P 500 EARNINGS GROWTH



Taking a longer-term view, our expected return model for the S&P 500 index (Chart 2) indicates that over the next seven years the outlook is for average annual returns of about 10%. Little should be expected from improved valuation, while the combination of profit growth and dividend yield indicates an average annual return of 10% is achievable. Actual results will vary as the profit cycle and valuation evolve, which in turn will also change the outlook for expected return. However, even a range of 5% on either side of that number would generate acceptable returns relative to cash and fixed income alternatives. We also know that the volatility of the equity markets will move that expected return dramatically within that seven year timeframe. Nevertheless, we are prudently optimistic based on the realization that market cycles typically carry prices from levels of undervaluation to overvaluation and that profit expansion has the potential to do better than simply match its long-term trend.

S&P 500 EXPECTED AND ACTUAL 7-YEAR ANNUAL TOTAL RETURN



We should also remain mindful of the relationship between the profits and valuation of U.S. equities, the vast bulk of which are accounted for by the few hundred largest companies dominating the S&P 500, and U.S. economic fundamentals. Increasingly, profit growth of these businesses is more closely linked to global growth than U.S. growth. We also note that publicly traded U.S. businesses – particularly outside the financial sectors – are in very good financial condition as measured by their liquid resources and borrowing capacity and cost.

Deficits Matter

To be sure, there are flaws in U.S. economic fundamentals that will bear on returns from financial assets. Chief among these would be the unsustainable deficit in the federal budget. Weak economic growth, reduced demand for consumer credit and the accumulation of dollar reserves outside the U.S. have led to the expansion of the deficit in recent years without serious interest rate implications. We should not expect that to continue indefinitely. Though faster economic growth and the eventual removal of stimulus measures and unemployment benefits will help reduce the deficit, a combination of additional reductions in spending and increased revenue will be required to restore the deficit to an acceptable level. We are encouraged by the ideas generated recently by the Simpson-Bowles commission and what appears to be a willingness of elected officials to begin addressing this issue.

Government deficits of another sort that will have to be dealt with sooner and will have a more immediate impact on the fixed income markets are those of certain states and municipalities that have been more severely affected by the economic downturn and the loss of real estate wealth. Another contributing factor in distressed state and local finances is the burden of unfunded pension obligations. Corporations learned long ago they could no longer commit to such generous long-term obligations and still preserve a competitive cost structure. Recent media coverage has highlighted the potential for a larger number, or even a vast wave, of defaults in the municipal debt markets, but the reality appears to us to be considerably different. Though we accept the conclusion that there may be a larger number of defaults this year, we also recognize that state and local revenues derived from personal income and profits are improving with the economy, while many such entities are cutting payrolls and other expenses. More will be required, but in the aggregate the situation appears to improving rather than deteriorating.

One prominent example of distress is California, which is facing an extremely large budget deficit that could impact its general obligation debt as well as that of counties dependent on state revenues for a portion of their budgets. Though this issue will in all likelihood be a source of volatility for California bonds in 2011, it seems unlikely to us that it will result in significant defaults that would permanently impair the value of municipal bonds in California. At Borel, individual California general obligation bonds no longer qualify for purchase based on their current credit rating. We have focused recently on stronger credits of issuers providing essential services or otherwise having more stable revenue sources. However, California law places service of the state government's debt ahead of most of its other financial obligations. A default would affect its future borrowing costs to an extent that would far outweigh any short-term advantage it might gain from such a maneuver.

In general, a default by a governmental entity is much more problematic than it is for an individual or business. Under current law, states cannot declare bankruptcy and though there is a section of the bankruptcy code for local governments (Chapter 9) it is by no means an attractive solution to financial distress. Almost half the states do not permit local government bankruptcies and those that do require state approval and intervention in the finances of the local government. Chapter 9 does not offer governments the protection of Chapter 11 but instead can require forced cuts in spending and increases in taxes. The other element in this equation to keep in mind is that municipal bond holders tend to be residents – and voters – of the state or locality issuing their bonds and would not look kindly on politicians opting for this solution.

There will be a variety of interests involved in the resolution of troubled state and local finances, including other taxpayers, public employee unions, and businesses. The process of restoring public finances in all forms to an acceptable level of stability will be a political process, which also means it will not be logical or orderly and could be a significant source of volatility in the capital markets. But in the end, politicians and their various constituent groups will learn that spending ultimately has to match revenue.

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TOTAL RETURN SUMMARY

Index Name	Current Yield	P/E Ratio	4th Qtr 2010	2nd Half 2010	1-Year	3-Year [1]	10-Year [1]	From Low 3/9/2009	From High 10/9/2007
			Total Return Through 12/31/2010						
Equities & Alternatives									
S&P 500 (U.S. Large Companies)	1.9%	15.9	10.8%	23.3%	15.1%	-2.9%	1.4%	93.1%	-13.6%
S&P 400 (U.S. Medium Size Companies)	1.3%	21.8	13.5%	28.4%	26.6%	3.5%	7.2%	130.5%	4.1%
S&P 600 (U.S. Small Companies)	1.2%	27.5	16.2%	27.4%	26.3%	3.0%	7.7%	133.7%	-2.0%
MSCI EAFE (International Developed Markets)	2.9%	15.5	6.7%	24.3%	8.4%	-6.5%	3.9%	93.9%	-20.8%
MSCI Emerging (International Emerging Markets)	2.1%	14.5	7.4%	26.8%	19.0%	-0.2%	15.6%	148.0%	-1.2%
FTSE NAREIT Equity REITS (Com'l Real Estate)	3.6%	N/A	7.4%	21.2%	27.9%	0.9%	7.3%	177.7%	-14.6%
Dow Jones UBS Commodities Index	N/A	N/A	15.8%	29.1%	16.7%	-4.2%	3.5%	54.9%	-6.3%
Gold (Spot price $/OZ)	N/A	N/A	8.6%	14.4%	29.5%	19.4%	18.0%	54.1%	92.5%
West Texas Intermediate Crude Oil ($/Barrel)	N/A	N/A	14.3%	20.8%	15.1%	-1.6%	13.0%	94.1%	13.9%
Fixed Income *(Barclays Capital Indices)*		**Avg. Maturity**							
U.S. Aggregate	3.0%	7.2	-1.3%	1.1%	6.5%	5.9%	5.8%	14.2%	22.4%
U.S. Treasury Aggregate	1.9%	6.8	-2.6%	0.0%	5.9%	5.1%	5.4%	5.0%	21.1%
U.S. Aggregate Credit Index (Corporate Bonds)	3.8%	10.1	-1.9%	2.7%	8.5%	6.8%	6.5%	29.4%	24.5%
U.S. Corporate High Yield (Below BBB-rated)	7.0%	7.0	3.2%	10.2%	15.1%	10.4%	8.9%	84.7%	31.8%
Global Majors ex-U.S.	2.1%	9.0	-1.2%	8.8%	7.0%	7.4%	7.4%	21.1%	30.1%
Global Emerging Markets	5.7%	10.8	-1.2%	8.0%	10.9%	8.0%	N/A	52.8%	28.4%
Municipal Bond (5 Year National Average)	2.5%	N/A	-1.6%	0.9%	3.4%	5.5%	4.8%	9.7%	19.8%

[1] Annualized

YIELD AND INTEREST RATES REVIEW

	Rates as of: 12/31/2010	6/30/2010	12/31/2009	2/28/2009	10/31/2006	12/31/2000
S&P 500 Yields						
Earnings Yield	6.35%	7.22%	5.54%	9.16%	6.18%	4.12%
Dividend Yield	1.87%	2.12%	2.11%	3.87%	1.78%	1.20%
Treasuries						
3-Month	0.14%	0.20%	0.05%	0.28%	5.09%	5.94%
6-Month	0.22%	0.25%	0.16%	0.49%	5.11%	5.74%
1-Year	0.27%	0.34%	0.49%	0.72%	4.93%	5.47%
2-Year	0.59%	0.63%	1.15%	1.01%	4.65%	5.11%
3-Year	1.03%	1.00%	1.66%	1.40%	4.62%	5.10%
5-Year	2.02%	1.80%	2.71%	1.96%	4.56%	5.06%
7-Year	2.72%	2.44%	3.42%	2.52%	4.59%	5.17%
10-Year	3.38%	2.96%	3.92%	3.05%	4.60%	5.06%
30-Year	4.32%	3.91%	4.63%	3.73%	4.71%	5.53%
Corporate Rates (Financials - AA)						
2-Year	1.69%	1.83%	2.16%	6.46%	5.16%	6.01%
3-Year	2.18%	2.29%	2.79%	6.79%	5.08%	6.12%
5-Year	3.39%	3.15%	3.79%	7.31%	5.21%	6.29%
7-Year	4.16%	3.91%	4.65%	8.14%	5.31%	6.48%
10-Year	4.69%	4.40%	5.15%	8.10%	5.46%	6.79%
Corporate Rates (Industrials - AA)						
2-Year	1.00%	1.14%	1.63%	2.73%	5.02%	5.86%
3-Year	1.58%	1.71%	2.39%	3.29%	5.12%	5.93%
5-Year	2.61%	2.57%	3.47%	3.91%	5.12%	6.03%
7-Year	3.46%	3.34%	4.26%	4.70%	5.01%	6.26%
10-Year	4.20%	3.94%	4.83%	4.90%	5.21%	6.40%
California General Obligation Issues (A1 / A-)						
2-Year	1.78%	1.21%	1.56%	2.49%	3.53%	3.99%
3-Year	2.24%	1.66%	2.00%	2.82%	3.58%	4.05%
5-Year	3.05%	2.64%	2.84%	3.34%	3.67%	4.14%
7-Year	3.79%	3.46%	3.81%	3.85%	3.74%	4.21%
10-Year	4.59%	4.28%	4.63%	4.53%	4.01%	4.40%

ECONOMIC SURVEY

	Periods		Data			
	Freq.	Recent	Earliest			Recent
Economic Aggregates						
GDP QoQ (Annualized)	Qtrly	12/31/10	3.7%	1.7%	2.6%	3.2%
Leading Indicators	Monthly	11/30/10	0.1%	0.6%	0.4%	1.1%
Personal Consumption	Qtrly	9/30/10	0.9%	1.9%	2.2%	2.4%
Personal Income	Monthly	11/30/10	0.5%	0.0%	0.4%	0.3%
Personal Spending	Monthly	11/30/10	0.5%	0.3%	0.7%	0.4%
Employment						
Unemployment Rate	Monthly	12/31/10	9.6%	9.7%	9.8%	9.4%
Change in Nonfarm Payrolls	Monthly	12/31/10	-24K	210K	71K	103K
Change in Private Payrolls	Monthly	12/31/10	112K	193K	79K	113K
Nonfarm Productivity	Qtrly	9/30/10	6.0%	3.9%	-1.8%	2.3%
Prices						
Consumer Price Index (MoM)	Monthly	11/30/10	0.3%	0.1%	0.2%	0.1%
Consumer Price Index (YoY)	Monthly	11/30/10	1.1%	1.1%	1.2%	1.1%
CPI Ex Food & Energy (MoM)	Monthly	11/30/10	0.0%	0.0%	0.0%	0.1%
CPI Ex Food & Energy (YoY)	Monthly	11/30/10	0.9%	0.8%	0.6%	0.8%
Retail Sales						
Advance Retail Sales	Monthly	11/30/10	0.9%	0.9%	1.7%	0.8%
Retail Sales Ex Auto & Gas	Monthly	11/30/10	0.9%	0.7%	0.8%	0.8%
Manufacturing						
ISM Manufacturing	Monthly	12/31/10	54.4	56.9	56.6	57.0
ISM Non-Manf. Composite	Monthly	12/31/10	53.2	54.3	55.0	57.1
Industrial Production	Monthly	11/30/10	0.2%	0.1%	-0.2%	0.4%
Capacity Utilization	Monthly	11/30/10	75.0%	75.1%	74.9%	75.2%
Confidence						
U. of Michigan Confidence	Monthly	12/31/10	68.2	67.7	71.6	74.5
Consumer Confidence	Monthly	12/31/10	48.6	49.9	54.3	52.5
Housing & Real Estate						
Existing Home Sales MoM	Monthly	11/30/10	7.3%	10.0%	-2.2%	5.6%
New Home Sales MoM	Monthly	11/30/10	-3.2%	12.4%	-10.7%	5.5%
S&P/CS 20 City MoM% SA	Monthly	10/31/10	-0.3%	-0.7%	-1.0%	-1.0%
S&P/CS Composite-20 YoY	Monthly	10/31/10	3.2%	1.6%	0.4%	-0.8%

BOREL INVESTMENT TEAM

Left to right: Investment Officer Margaret Park, Chief Investment Officer Randall Matthews, Senior Investment Officer & Department Head Nancy Johnson and Portfolio Manager Melody Po

For over 30 years, Borel Private Bank & Trust Company has been providing investment, retirement, fiduciary and private banking services in an integrated fashion to meet your wealth management needs. Our clients benefit from our relationship approach, delivered by a team of experts.

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Our Investment Management team prides itself on experience, stability and continuity, as well as an unwavering commitment to your financial success. For more information about our Investment Management Services, or to make an appointment with an Investment Management Officer, call 650.378.3720, or go to our website at www.borel.com.

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