SaratogaRIM.com

2009 Quarterly Report

April 16, 2009

Q1

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Market Statistics

Source: Barron's (Mar. 30), Federal Reserve,
* Spot prices (Mar. 31)

Stocks		Yields (%)				Commodities	
DJIA	7,609	Fed Funds	0-.25	US Tr. 3-Y	1.28	CRB Futures	369
P/E ratio	25.79	Disc. Rate	.50	US Tr. 5-Y	1.75	Gold ($/oz)	924
S&P 500	798	Libor 1-Mo	.52	US Tr. 10-Y	2.75	Silver ($/oz)	13.65
P/E ratio	28.38	US Tr. 1-Y	.64	US Tr. 20-Y	3.78	Crude ($/bbl)* (NYM Light Sweet Crude)	49.66

Saratoga Research & Investment Management
14471 Big Basin Way, Suite E ■ P.O. Box 3552 ■ Saratoga, CA 95070

SARATOGA RESEARCH & INVESTMENT MANAGEMENT

EST. 1995

Letter to Investors

"There was a 16-month recession between July 1981 and November 1982. Actually this was the scariest time in my memory. Sensible professionals wondered if they should take up hunting and fishing, because soon we'd all be living in the woods, gathering acorns. This was a period when we had 14% unemployment, 15% inflation and a 20% prime rate, but I never got a phone call saying any of that was going to happen.

Then at the moment of greatest pessimism, when eight out of ten investors would have sworn we were heading into the 1930s, the stock market rebounded with a vengeance, and suddenly all was right with the world." - Peter Lynch

The stock market meltdown continued into the first quarter of 2009. In a sharp selloff between January and early March, the Dow lost nearly another third of its value (falling more than 50% below its 2007 peak). The market then staged a furious rally to regain nearly two thirds of its year-to-date losses by quarter's end. Even after climbing some 1,500 points to top 8,000, the Dow Jones Industrial Average finished the quarter down another 13.3%. Our Equity & Strategic Income Composites were down 5.07% and 2.65% respectively in Q1.

We don't know if the market has hit bottom yet. We expect that the current recession will continue through at least late 2009, creating a volatile market environment over the coming several quarters. The good news: extreme volatility in Q1 created what we believe will prove to have been great buying opportunities. We are confident that we made a number of great investments during this time frame and that we will eventually look back and marvel at the bargain prices that were available. We expect to continue making selective purchases in coming months as huge market swings continue to present opportunity.

During the 12 months ending March 31, 2009, our Equity and Strategic Income Composites were down 14.91% and 11.38%, respectively. That compares to -37.95% on the Dow, -38.09% in the S&P 500, -50.38% for the Value Line Composite Index, -43.48% in the MSCI World Index, 2.64% by the Citigroup Investment Grade Bond Index and 1.61% in 90-day Treasury bills. Although we never celebrate losses, our relative performance was consistent with our expectations given the severe global recession and extreme market volatility. The SEC requires us to mention that past performance is not a guarantee of future returns. (See Disclosures.)

We view ourselves as value driven equity investors - that's what we do, and basically all we do. We invest in great businesses when we can buy them for significantly less than they're worth, and we take profits when prices rise too far. What differentiates us from other value investors is that we don't start off looking for cheap stocks. Rather, we begin our process by seeking out great businesses. Consequently, as we tend to invest in businesses that are far more profitable than what are typically deemed "value stocks," our brand of value investing has a distinctive growth flavor. Indeed, from the outside looking in, we understand how a consulting firm might want to use us as part of a "growth mandate."

Our objective is simple, straight forward and totally style box agnostic. Our goal is to outperform the market over time (create alpha) with less risk. Our clients have clearly achieved this objective. Regardless of whether you look at one, three, five, or seven year performance, our Equity Composite has not only outperformed the markets but also the vast majority of other equity managers and mutual funds as well. This is true all the way back to our Equity Composite's inception in February of 2000. There have certainly been periods when we underperformed; but in aggregate, our cumulative performance has been exemplary.

We don't consider this success an accident. None of us gets to choose the market environments that will exist during our investing lifetimes, and everybody has the same set of investment options to select from. From its inception, our investment process was designed to excel over the long term despite the constantly changing economic and market environments we believe to be the norm.

After being poked and prodded in a yearlong due diligence process, we recently signed a sub-manager agreement with Beacon Pointe Consulting down in Newport Beach to manage equity portfolios for their institutional and high-net-worth clients. We were very impressed by how thorough they were in evaluating us, and are very proud to have been selected by this respected firm as one of their equity managers. Over recent months we have also received an influx of client referrals and we want to thank you for thinking of us. We want to welcome all of our new clients for whom this is our first quarterly report. We're excited to be working for you and look forward to what we expect to be a long and mutually profitable relationship.

Recently, Beacon Pointe asked us to comment on our outlook for future inflation and describe portfolio strategies we were implementing in preparation. It was a timely question and we wanted to share our response with the rest of our clients. The remainder of this report is an edited version of our response to their investment committee.

Always looking forward,

Kevin Tanner
President & Chief Investment Officer

"Common yardsticks such as dividend yield, the ratio of price to earnings or to book value, and even growth rates have nothing to do with valuation except to the extent that they provide clues to the amount and timing of cash flows into and from the business. Indeed growth can destroy value if it requires cash inputs in the early years of a project or enterprise that exceed the discounted value of the cash that those assets will generate in later years. Market commentators and investment managers who glibly refer to "growth" and "value" styles as contrasting approaches are displaying their ignorance, not their sophistication. Growth is simply a component - usually a plus, sometimes a minus - to the value equation." **- Warren Buffett**

Despite bumps in the road, we are fans of the modern capitalist system. Yet while we recognize it as the best socio-economic structure yet developed, like all manmade institutions it is imperfect. One major flaw is the inherent boom-bust cycle that renders capitalism inherently unstable. Complicating matters, political leaders and the government institutions they oversee are forever meddling, so for better or for worse we never get to see how Adam Smith's invisible hand would ultimately deal with capitalism's more unpleasant side-effects. Much to our chagrin, and despite the best of intentions, the best laid plans policymakers can agree on oftentimes don't work. Or they work for a time, then come back to bite us where and when we least expect.

I began my career when Ronald Reagan was in the White House, but my personal political awareness dates through the Carter, Ford and Nixon eras. I have seen gas lines and inflation. As a professional investor I experienced the market crash of October '87, and I've worked in breathtaking bull markets and wicked bear markets exacerbated by wars and terrorist attacks. Along the way, I've seen idiots make fortunes and intelligent people lose everything - and I'm talking about professional investors.

I expect, knock on wood, to be investing through another five or so presidential administrations. Over that time frame, I am certain that we will encounter numerous extreme economic environments, some of which will resemble what we've seen before while others will be entirely new. Forecasting alone can't prepare us. Some of the defining events of the last quarter century were predictable, to be sure, but others simply weren't. That's how the future is going to be - full of challenges and surprises. My job is to accept that fact and be as prepared for the consequences as I can be. That's why I built our security selection process based on the assumption – indeed, a sense of certainty – that every company we own would eventually confront devastating recessions and sustained bouts of inflation.

That brings us to the subject at hand: inflation.

Inflationary Consequences

Over the past year, the Federal Reserve has tripled the size of its balance sheet, and by the time they are done it is difficult to imagine that they won't have at least quadrupled it. It's not just the Fed, either. Central banks around the world are running the printing presses at full speed, as governments spend trillions in synchronized, if not coordinated, efforts to prime the engines of global growth and propel the world beyond the current financial crisis. Someday, they will be successful. Soon thereafter there will be a whole different kind of hell to pay.

Eventually, the money printed in such vast quantities to alleviate the current global financial crisis is quite likely to manifest itself as much higher inflation rates than investors have become accustomed to. Investment ramifications will be significant. Interest rates will rise across the entire yield curve, and the purchasing power of cash will be reduced, perhaps dramatically. In real terms, over the next decade we expect well chosen equities to outperform both cash and bonds. This will be especially true relative to Treasuries.

We are intrigued by the many future ramifications of both the deleveraging process currently underway globally and the policy responses it has engendered. To this point, massive public cash injections have simply served to help offset the impact of sharply reduced velocity in the money supply. The catalyst for the sharp contraction in lending activities by the aggregate banking (and shadow banking) system, of course, was the collapse of the securitization markets. The subsequent downward spiral in the real economy is largely a reflection of the sudden end of an era defined by cheap and abundant credit.

Until now, the cumulative effect of all the money that has been pumped into the system has been largely limited to offsetting the deflationary ramifications of deleveraging. Policy makers are not going to stop until the banking sector and credit markets find some solid footing and the global economy shows clear signs of gaining traction. Ultimately, they will tinker with mark-to-market

accounting rules and print as much cash as is necessary to achieve these "win at all cost" mandates. Eventually they will win - and the aggregate banking system will begin to create credit again, at which point the magic of the multiplier effect will begin to hit the money supply. Going forward, we think a much more inflationary environment is likely to take hold once all the pump-priming has its effect.

The impact of this sea change will be magnified by the fact that the American financial system is populated by a generation of money managers with little experience dealing with real inflation.

Long Term Alpha's Not an Accident - You Get What You Prepare For

As long term investors, we purchase every stock knowing that there will likely be significant political turnover during the period in which we hold it. Control of Congress will alternate and there may be several sitting presidents between our initial nibble and ultimate sale. Also embedded in our process is an understanding that capitalism is inherently unstable. We accept that our political and economic systems create headwinds and tailwinds and we build this understanding into our approach. In fact, we plan for bouts of depression and inflation to occur with greater frequency than most investors appreciate.

Rather than trying to flip-flop between investment styles in a never ending effort to react to constantly changing economic and market landscapes, we have designed our investment process specifically to allow us to focus our attention on businesses that share a very rare set of common characteristics. Most companies can put up at least reasonable numbers when times are good. Our portfolios are populated by a special breed -- companies that are not only likely to survive a depression (due to their strong balance sheets, lack of excessive leverage and overall financial strength) but also structured to outperform during inflationary cycles - as a result of their pricing power and non-capital intensive business models. It’s a rare business that can do both to our satisfaction.

It has been interesting to see how different parts of our investment process have taken turns in driving our alpha during different economic environments. It’s almost like a relay team with one runner passing the baton to the next. From our composite inception on 2/29/2000 through 12/31/2006, our valuation work and the portions of our screening process that focused us on businesses that more often than not earned above average profit margins and efficiently utilized retained earnings enabled us to outperform the S&P 500 by 54.95 percentage points after fees.

But until 2007, our performance (respectable though it was) never truly benefitted from the part of our screening process that avoided excessive leverage in favor of stellar balance sheets. Indeed, from 2004 to 2006, many of Wall Street's darlings were very heavily leveraged, and although they had what we identified as miserable balance sheets, they soared nonetheless. These included banks, mortgage companies, brokerages and home-builders that were too heavily indebted for our tastes. Since then, of course, they've collectively given all their profits from those froth years -- and more -- back to the market. We knew at the time that avoiding them wasn't helping our short term relative performance but, honestly, we didn't care. Excessive leverage is the root of history's greatest financial disasters. Anyone who plays with fire for long enough ends up in the burn unit.

If the dot.com boom and bust didn't teach investors that lesson nearly a decade ago, more recent history should prove that it’s silly to worry too much about short term performance in a market where everyone else is being stupid. From 12/31/2006 through 3/31/2009 our valuation work and the portion of our screening process which steered us away from excessive leverage enabled us to outperform the S&P 500 by 33.57 percentage points.

We mention this because there is another portion of our screening process that has yet to grab the baton and demonstrate its alpha generating capabilities, as we will discuss next.

MCAPEX: Next Alpha Driver - Ready to Grab the Baton

In coming years, as inflationary pressures intensify we expect another one of our screens to step up and prove every bit as valuable to our clients as the rest of our process has. One of the characteristics common to all of our holdings is that they generate very high quality owner earnings. We define owner earnings as cash flow minus maintenance capex - MCAPEX - (the latter being the portion of a company's capital expenditures required simply to maintain its current competitive position). From our perspective, there is a direct relationship between how capital intensive a business is and the quality of its owner earnings. This relationship is magnified during periods of high inflation and is mathematically embedded in our screening process.

MCAPEX is not an item that is broken out in financial statements; it must be estimated by relating various other financial statement data points over time. It was Charlie Munger who gave us the methodology that we used to develop our proprietary screening module and explained its importance to us. In his example, MCAPEX can be thought of as the money the owner of an apartment building would set aside monthly to replace the roof every twenty years or so, as opposed to money spent building additional apartment units (which would be growth capex). The former, but not the latter, must be subtracted from cash flow to determine actual owner earnings.

This distinction is important because capital expenditures are not operating expenses. During inflationary periods, capital intensive companies that have to continually reinvest large portions of their earnings just to tread water (read: companies with large MCAPEX) tend to dramatically underperform. This is true even for companies that have pricing power. Indeed, even if they can raise their prices as fast as the overall rate of inflation, they must plough even more cash generated by profits back into the business simply to maintain their current competitive position and shareholders are earning less than they think they are. Conversely, businesses that have modest maintenance capital expenditure requirements tend to dramatically outperform during inflationary periods because more of the earnings growth is real and can accrue to the benefit of shareholders. Our process uses five related screens to eliminate from further consideration all companies we deem to be too capital intensive.

Beacon Pointe's request that we present our inflation outlook and discuss our coping strategies was timely. As we have explained, our selection process has embedded inflation protections, so other than owning a little gold and silver instead of dollars we're not doing anything out of the ordinary despite our expectation that inflation could intensify. Yet we have not, in actual fact, ever managed through a prolonged inflationary environment (I was 12 in 1974), so we felt compelled to justify our confidence. To do that, we commissioned Standard & Poor's to back-test the portion of our process related to MCAPEX just described above. Specifically, we had them isolate a module consisting of our five separate proprietary SaratogaRIM screens (that S&P has promised not to use or otherwise divulge) and test them against the harshest inflationary conditions we could conjure - the latter half of the 1970's. S&P then took our screening results and simulated performance as it would have occurred during the measurement period.

Validation by Backtesting

For obvious reasons, I can't divulge the entire back-testing report. The results are profound. Of course, past performance and/or back-testing results do not guarantee future returns. However, if it turns out that we actually do experience a prolonged period of heightened inflationary pressure in the coming years, we expect to radically outperform.

Keep in mind: ALL of the companies that pass our screening process today possess the very same characteristics identified by the screens used in the simulation conducted by Standard & Poor's. Also remember that this simulation includes no other aspects of our investment process, and that our four other screening modules should also add additional alpha during an inflationary environment. Lastly, these results also omit all valuation work.

Nevertheless, from the bear market low in September of 1974 through the end of 1980 (by which time Fed Chairman Paul Volcker had stepped in to snuff out inflation), the basket of stocks selected by our proprietary screening module in the backtesting simulation rose in value by 248.53% and outperformed the S&P 500 by 134.87 percentage points. The S&P 500 and inflation, as measured by the consumer price index, were up 113.66% and 69.17% respectively over the same time frame.

In short, this test strongly validates the intuitively obvious inflation-beating attributes of this portion of our screening process. (see Fig. 1 on the next page)

Other Factors

Above and beyond the screening process, we also think a lot about sustainable competitive advantages and companies that possess them. This concept is also referred to as "the business moat." The stronger the advantage, the wider the moat. One type of moat protects firms that make or provide differentiated products or services where the cost of the differentiation is lower than the price premium the company can charge. Usually, attributes that render the product or service unique also manifest themselves in brand loyalty, which is a positive in all economic environments. Such moats can shield businesses during recessions and can afford pricing power during inflationary periods.

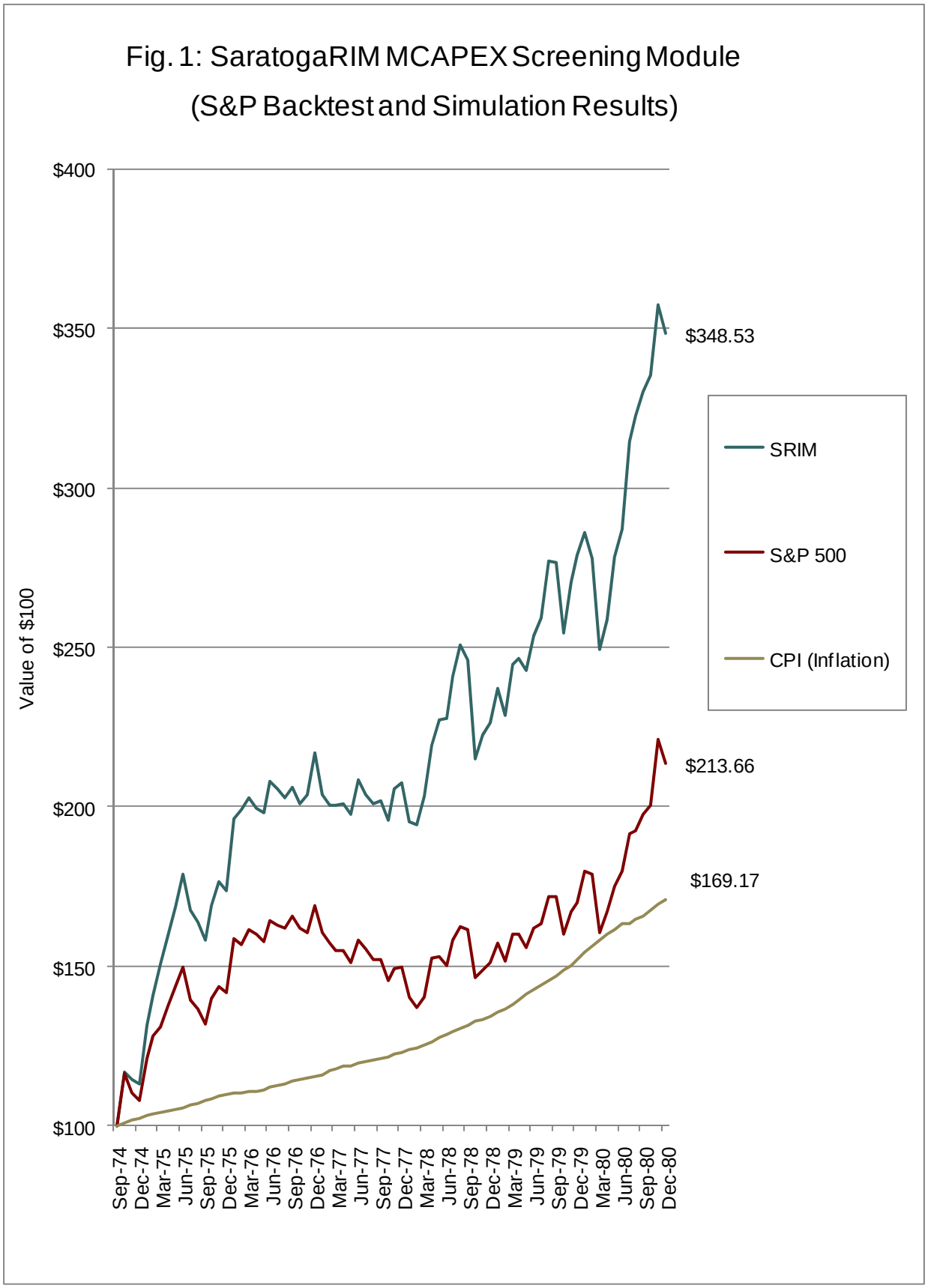
Here are two examples: Apple Inc. has a formidable moat in the form of strong brand loyalty which enables the firm to price its Macintoshes at a premium to PCs. Harley Davidson also has awesome sustainable competitive advantages. Its customers too are fiercely brand-loyal, so Harley can command a premium price over Honda and Suzuki. Once inflation sets in, it will be far easier for these two companies to raise prices without losing sales to competitors than it will for their competitors to do likewise. Should inflation emerge, as we suspect it will, most of our companies will enjoy relative pricing power advantages over their respective competitors. We believe that these pricing advantages, combined with the fact that all of our companies have modest maintenance capital expenditure requirements and aren't heavily leveraged will blunt the impact of rising interest rates. Indeed, some of our holdings would actually benefit from rising interest rates. We expect our security selection process to shine in coming years regardless of whether inflation reemerges or not. As the S&P back-testing shows, the portion of our screening process meant to gauge the quality of owner earnings would have produced huge profits and alpha in the wake of the 1973 - 74 bear market and the inflation that haunted the latter half of the 1970s. We believe they would do so again should inflation emerge.

It is imperative to understand that the above strategies represent key investment principles for us. We aren't doing anything differently today because we think inflation is coming. We were just as prepared for it a decade ago, and we'll be just as ready a decade from now. As long term investors, we're always ready for inflation or depression.

Thinking Outside the Box

In addition to our core security selection process, we will also consider investment ideas that complement our core approach. For example, as an alternative to holding cash, we currently hold roughly 2.5% to 3% of our portfolios in a gold ETF and the same percentage in a silver ETF. We believe that this is attractive and prudent for two reasons: (a) we believe that gold & silver will hold their purchasing power during an inflationary environment - see Fig. 2; and (b) with money markets yielding close to zero, and considering that money market funds may not be entirely risk free (Treasury funds included), we think there is a positive risk/reward tradeoff.

We are also willing to research stock ideas that we don't generate through our traditional screening process. Although the vast majority of our holdings do in fact come from our screening, we have from time to time uncovered “outside the box gems” in the past.

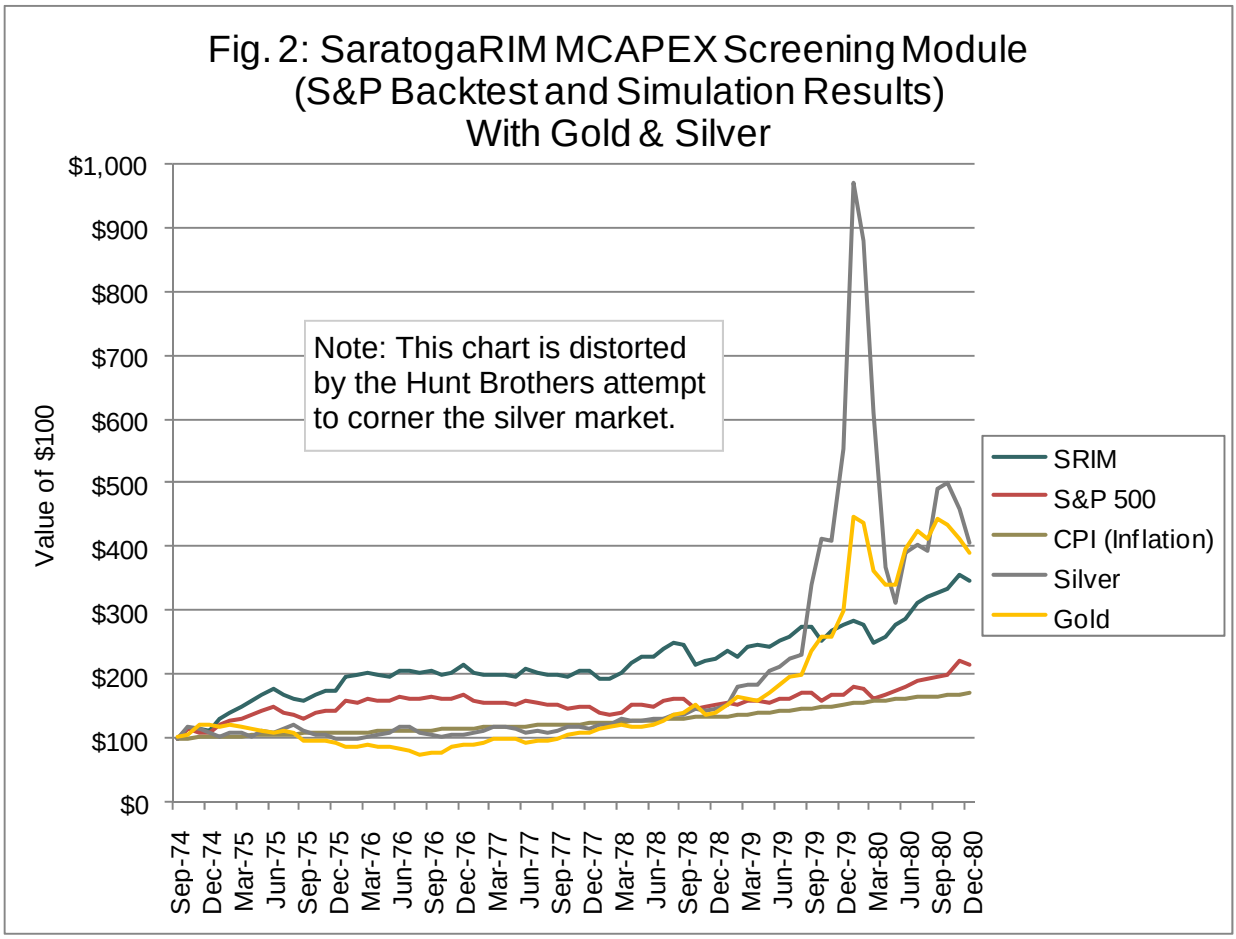


Note: Backtesting results do not guarantee future performance

Conclusion

Our brand of value investing is forward-looking and built to outperform over complete market cycles measured either peak-to-peak or trough-to-trough. Our process has been designed from the vantage point of a long term investor, hence we don't need to adjust our investment approach every time the economic climate changes. We like to invest in businesses that we expect to outperform over the long term regardless of whether we are in a recessionary or inflationary environment. Thus the title of this paper: Semper Paratus is Latin for always prepared.

The tradeoff for our long term outperformance is that during times when the rest of the investment community fools itself into mispricing risk we sometimes underperform. We consider this a small price to pay for being able to win over the long term. We believe that we would significantly outperform the markets and the vast majority of our competitors if we see a significant uptick in inflation in coming years.



Note: Backtesting results do not guarantee future performance

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If you have any questions or would like a written copy of our form ADV sent to you, please feel free to contact Kevin Tanner at our physical address and contact details listed below:

Kevin Tanner
Saratoga Research & Investment Management
14471 Big Basin Way, Suite E
Saratoga, CA 95070

E-mail: kevin@saratogarim.com
Tel: (408) 741-2333
Fax: (408) 741-1032

Saratoga Research & Investment Management, Inc.

PERFORMANCE HISTORY
NET OF FEES
SRIM Managed Equity Composite
From 03-31-08 to 03-31-09

Time Period	Percent Return Per Period						Cumulative TWR Basis = 100					
	SRIM Equity Composite	Dow Jones	S&P 500 Total Return	NASDAQ	Value Line	MSCI World	SRIM Equity Composite	Dow Jones	S&P 500 Total Return	NASDAQ	Value Line	MSCI World
03/31/08							100.00	100.00	100.00	100.00	100.00	100.00
03/31/08 to 04/30/08	1.11	4.54	4.87	5.87	4.06	5.26	101.11	104.54	104.87	105.87	104.06	105.26
04/30/08 to 05/31/08	2.10	-1.42	1.30	4.55	2.91	1.52	103.24	103.06	106.23	110.69	107.08	106.86
05/31/08 to 06/30/08	-1.73	-10.19	-8.43	-9.10	-11.02	-7.98	101.45	92.56	97.27	100.61	95.28	98.34
06/30/08 to 07/31/08	-2.06	0.25	-0.84	1.42	0.44	-2.44	99.36	92.78	96.46	102.04	95.70	95.94
07/31/08 to 08/31/08	-0.10	1.46	1.45	1.80	2.84	-1.40	99.27	94.14	97.85	103.88	98.42	94.59
08/31/08 to 09/30/08	-1.67	-6.01	-8.91	-12.05	-9.08	-11.89	97.61	88.48	89.13	91.37	89.48	83.34
09/30/08 to 10/31/08	-6.75	-14.06	-16.80	-17.35	-26.53	-18.96	91.02	76.04	74.16	75.51	65.74	67.54
10/31/08 to 11/30/08	-1.87	-5.32	-7.18	-10.77	-15.06	-6.47	89.32	72.00	68.84	67.38	55.84	63.17
11/30/08 to 12/31/08	0.36	-0.60	1.06	2.70	3.61	3.21	89.64	71.57	69.57	69.20	57.86	65.19
12/31/08 to 01/31/09	-2.55	-8.84	-8.43	-6.38	-9.83	-8.76	87.35	65.24	63.71	64.78	52.17	59.48
01/31/09 to 02/28/09	-6.35	-11.72	-10.65	-6.68	-13.70	-10.24	81.81	57.60	56.93	60.46	45.02	53.39
02/28/09 to 03/31/09	4.01	7.73	8.76	10.94	10.21	5.86	85.09	62.05	61.91	67.07	49.62	56.52
Trailing 12 Months												
03/31/08 to 03/31/09	-14.91	-37.95	-38.09	-32.93	-50.38	-43.48						
Annualized	-14.91	-37.95	-38.09	-32.93	-50.38	-43.48						
Last 3 Years												
03/31/06 to 03/31/09	1.78	-31.51	-34.28	-34.67	-56.64	-36.87						
Annualized	0.59	-11.85	-13.06	-13.23	-24.31	-14.22						
Last 5 Years												
03/31/04 to 03/31/09	13.15	-26.54	-21.66	-23.35	-48.59	-17.64						
Annualized	2.50	-5.98	-4.76	-5.18	-12.46	-3.81						
Last 7 Years												
03/31/02 to 03/31/09	22.79	-26.86	-20.36	-17.17	-48.77	-10.17						
Annualized	2.98	-4.37	-3.20	-2.65	-9.11	-1.52						
Inception to Date												
02/29/00 to 03/31/09	58.56	-24.87	-31.35	-67.45	-51.82	-31.13						
Annualized	5.20	-3.10	-4.06	-11.62	-7.72	-4.02						

Past performance is not a guarantee of future results.

Saratoga Research & Investment Management, Inc.

PERFORMANCE HISTORY
NET OF FEES

SRIM Managed Income Composite

From 03-31-08 to 03-31-09

Time Period	Percent Return Per Period			Cumulative TWR Basis = 100		
	SRIM Equity Composite	Investment Grade Bonds	90-Day T-Bills	SRIM Equity Composite	Investment Grade Bonds	90-Day T-Bills
03/31/08				100.00	100.00	100.00
03/31/08 to 04/30/08	2.59	-0.26	0.12	102.59	99.74	100.12
04/30/08 to 05/31/08	1.40	-2.03	0.06	104.03	97.72	100.19
05/31/08 to 06/30/08	-1.70	0.94	0.25	102.26	98.64	100.44
06/30/08 to 07/31/08	-2.39	-0.91	0.19	99.81	97.74	100.63
07/31/08 to 08/31/08	0.45	1.74	0.16	100.26	99.44	100.79
08/31/08 to 09/30/08	-4.11	-3.81	0.41	96.14	95.66	101.20
09/30/08 to 10/31/08	-4.12	-7.18	0.12	92.18	88.79	101.32
10/31/08 to 11/30/08	-2.14	10.20	0.12	90.20	97.85	101.45
11/30/08 to 12/31/08	0.92	10.99	0.00	91.04	108.60	101.45
12/31/08 to 01/31/09	-0.96	-6.09	0.03	90.16	101.98	101.48
01/31/09 to 02/28/09	-5.66	-1.59	0.00	85.06	100.35	101.48
02/28/09 to 03/31/09	4.19	2.28	0.12	88.62	102.64	101.61
Trailing 12 Months						
03/31/08 to 03/31/09	-11.38	2.64	1.61			
Annualized	-11.38	2.64	1.61			
Last 3 Years						
03/31/06 to 03/31/09	8.19	17.67	11.94			
Annualized	2.66	5.57	3.83			
Last 5 Years						
03/31/04 to 03/31/09	28.30	23.82	17.67			
Annualized	5.11	4.37	3.31			
Inception to Date						
12/31/02 to 03/31/09	45.40	37.65	19.41			
Annualized	6.18	5.25	2.88			

Past performance is not a guarantee of future results.

The above summary/prices/quotes/statistics contained herein have been obtained from sources believed reliable but are not necessarily complete and cannot be guaranteed.

SARATOGA RESEARCH & INVESTMENT MANAGEMENT

EST. 1995

SaratogaRIM.com

Saratoga Research & Investment Management
14471 Big Basin Way, Suite E ■ P.O. Box 3552 ■ Saratoga, CA 95070
Tel: (408) 741-2333 ■ Fax: (408) 741-1032 ■ E-mail: kevin@saratogarim.com