PILLAR PACIFIC CAPITAL MANAGEMENT, LLC

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Mindy L. Ying, MBA
President & CEO

Arthur T. French, CFA, CIC
Chief Investment Officer

Sonny C. Lin, CFA, CIC
Senior Portfolio Manager

Lily L. Ku, CFP®
Financial Planner

Chih-Lin Su, MBA, MSF
Financial Consultant

Joseph Fontamillas
Client Service Manager

Carmen Pon
Operations Manager

Jennifer S. Ying, CPA
Financial Consultant

Corey H. Liu, MBA
Financial Consultant

Offices:

Southern California:
2540 Huntington Dr.
Suite 105
San Marino, CA 91108
Tel: (626) 286-4029
(888) 295-4419
Fax: (626) 286-0624

Northern California:
333 Gellert Blvd.
Suite 121
Daly City, CA 94015
Tel: (650) 758-0130
Fax: (650) 758-0131

www.PILLARPACIFIC.com

~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

While the economy continues to expand, large portions of the country have been beset by a relentlessly brutal and challenging winter. The Midwest and Northeast have been "weathered in" for much of the past three months, and related transportation disruptions have taken a toll across the rest of the country. Already, we see articles pointing to "frugal consumers" as a source of slower consumer spending, and maybe slower economic growth, in the first quarter. As we enter earnings season, there are bound to be company specific earnings disappointments. However, we take a more sanguine view. **Much of the potential disappointment is already factored in and we see the concern over this recent winter weather as merely a temporary impediment to a rising stock market.**

Rather than spending time talking about the weather and speculating on events which are past, we thought we would share our thoughts on a persistent financial market myth. A myth is a traditional story which explains a practice or belief which may or may not be true. In this case, the myth we would like to discuss is portfolio yield or, more specifically, dividend yield. **Many of us believe dividend income is somehow superior to realized gains. It is no longer true, if it ever was.**

Perhaps the myth persists because of the tradition in trust law to segregate the interests of an income beneficiary from remainder interests. For years, bank trust departments produced statements which accounted for income separately from principal, giving rise to the notion that one should never "invade" principal. **This practice had the unintended consequence of producing less than optimal asset allocations.** These days, trusts are generally constructed to allow the income beneficiary the ability to "invade principal" by distributing a percentage of the portfolio's asset value to balance the income beneficiary's interests with remainder interests. This allows portfolios to be structured to balance investors' preferences for risk and return.

Until 1958, stock dividend yields were generally higher than the interest paid by bonds. This was due to the belief that investors needed higher yield because stocks were an inherently riskier asset class than bonds. From the sixties until recently, dividend yields have been lower than bond yields for a number of reasons. **Perhaps the most obvious of these reasons is that stocks have the potential to participate in the growth of earnings.** Although both attitudes toward dividend yield were widely accepted at the time, it is safe to assume that the bias toward higher and lower dividend yield was shaped by constraints and subsequent changes in trust law.

Also in 1958, Franco Modigliani and Merton Miller first proposed a theorem which they refined over the subsequent two decades. The Modigliani-Miller Theorem is a theory of capital structure which, given certain assumptions, states that the value of a firm is unaffected by how that firm is financed. **It does not matter if the firm's capital is raised by issuing stock or selling debt.**

In an article written in 1961 and revised in 1977, Modigliani and Miller also affirmed that a firm's value is independent of dividend policy. Since then, dividend policy has been examined extensively by an entire generation of economists. Several caveats have evolved, but the theorem remains the framework for understanding capital structure. Modigliani won the Nobel Prize in 1985 and Miller in 1990 in recognition for their contributions to financial economics.

We mentioned that this theorem hinges on certain assumptions. Since this article is concerned with comparing the relative value of dividend yield to capital gains, we will focus on that aspect of the theorem. In other words, if you need cash flow from your portfolio to meet expenses, should you prefer that cash come from a dividend or from the sale of shares of stock which provide realized gains (or losses)? According to the theorem, if you assume that the tax rate on capital gains is equal to the tax rate on dividend income, you should be indifferent between the two sources of the funds you are taking from your portfolio. After all, money is money! **However, if you consider the flexibility to time a sale of stock, and the ability to choose the allocation of the sale between realized gains and losses, the balance begins to tilt in favor of growth over yield for an investor in individual stocks and bonds.**

Fixed Income Market

Fixed income securities are most likely in the middle of a trading range, with the benchmark ten year U.S. Treasury bound in a range of 2.5-3%. This could continue for another year or more. The Federal Reserve Bank continues to provide ample stimulus through its quantitative easing program, in spite of the announcement that it has embarked on a program of tapering the stimulus. It is likely that this tapering will be gradual, continuing the stimulation which is keeping interest rates low. **With the Federal Reserve Bank concerned about causing any disruption to the financial markets, we think we will see the Fed continuing to provide stimulus to the markets well into next year.**

The bond market has had a long bull market run, going back to the early 1980s with only minor interruptions. **For most of this time, bond strategies have been designed to generate excess returns in a declining interest rate environment by "reaching for yield," e.g. by extending duration (maturities) or buying bonds of lower credit quality.**

We really haven't experienced an extended period of rising interest rates since the decade of the 70's. **An interesting strategy of that era was designed to capture interest on interest.** It was a strategy pursued by large institutional investors based on the understanding that there are three components of a bond's return: return of principal, coupon interest, and interest earned from reinvesting the coupon payments at ever higher rates over the life of the bond. In a rising rate environment, this last source of return is the most significant.

We realize that most of our clients are not institutions with coupon payments sufficiently large to afford us the opportunity to reinvest this cash flow in bonds with higher interest rates. Instead, we have designed your fixed income portfolios with "laddered" maturities of short duration bonds. **As each of these bonds mature, we will invest the proceeds in new bonds, at higher rates. In this way we can maintain overall portfolio stability, meet your cash flow needs in times of extreme market volatility, and increase your current yield over time.**

International Market

Emerging from the worst crisis since the introduction of the euro, Europe seems to have regained traction on its economic road to recovery. While many emerging markets continue to be troubled by inflation, European markets have been the bright spot for international investing.

But the European economic recovery has not been easy. During its darkest days, the sovereign debt crisis led to skepticism about the future of the European Union and the survivability of the euro. However, the European countries used this crisis as an opportunity to force serious reforms which may never have happened had it not been for the threat of default. Voluntarily, and in some cases involuntarily, **authorities have implemented massive structural reforms and fiscal budget rebalancing. The results appear positive.** A prime example is Ireland, which implemented various measures of internal devaluation such as wage cuts and pension and labor reforms. The country not only exited the troika's (IMF, ECB and European Commission's) rescue program last year, but is also on course to positive GDP growth this year.

In aggregate, current account balances in the euro zone have returned to surplus and now stand at 15-year highs. Meanwhile, unit labor costs are trending lower, indicating further improvement to the region's competitiveness. The recent news that European car sales are on the rise could serve as another signal that the improvement of the economy is indeed sustainable. European car sales had suffered a six-year slump, falling to the worst level in 20 years as consumers reduced expensive purchases in reaction to austerity programs and uncertainty about job security. **As the consensus begins to believe the recovery is sustainable, it will reinforce consumer confidence and boost demand for consumer durables such as automobiles.**

It is actually extraordinary that Europe has implemented these tough reforms without having to depreciate its currency. The strength of the euro should be seen as a sign of confidence in the region, validating the current structural and economic reforms. Also, for U.S. investors, a stable euro is beneficial as the U.S. dollar dominated return will not be eroded by a devalued euro.

Although we see continuing positive developments in Europe, the recent heightening of geopolitical tension between Russia and the West has cast a shadow over the region. **The Ukrainian crisis poses a serious challenge to the European Union's energy policy.** This is significant considering the region's heavy dependence on Russia for its energy needs. In addition, many European countries, such as Germany, have extensive business ties with Moscow. Although the outcome is still to be determined, recent developments appear constructive with both sides appearing to refrain from further escalation. **We believe the conflict will eventually fade and markets will return to normal.** Nevertheless, we are keeping a close eye on this situation, ready to make adjustments if necessary.

With European manufacturing data and other indicators pointing to continuing economic recovery, we believe the region has much further to go. Euro zone inflation consistently surprises on the downside; with inflationary pressure low, there is more room for European Central Bank stimulus if needed. **In our opinion, the European financial markets are undervalued and remain a focus of our current international exposure.**