PILLAR PACIFIC CAPITAL MANAGEMENT, LLC

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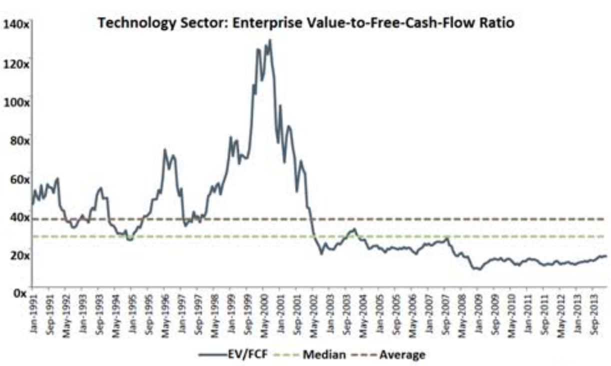
~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

The benchmark Dow Jones Industrial Average and the Standard & Poors 500 are setting record highs. While this is good news for those of us who invest in stocks, it does cause some to question whether the market is overvalued and poised for a correction. **We believe the current bull market has a long way to go, even though it is always vulnerable to correction.**

We will start out by addressing valuation. The financial crisis and market correction of 2008-2009 wreaked havoc on equity valuations. As usual, the stock market over-reacted to the difficult circumstances of the time. But the early stage of the market recovery in 2009-2010 was a return to an equilibrium market valuation in a process called mean reversion; there is after all a relationship between business fundamentals and stock prices. **Since then, valuations have mostly tracked earnings and stocks have never really attained excessive price levels.** In the chart below we show this with an illustration of the changing valuation of the technology sector. We chose technology because it is often accused of being overvalued and because it is a fairly significant component of the total market capitalization. It is also representative of opportunities still available to equity investors.



Source: FMRCo, Haver Analytics, as of 3/31/14. Sector data taken from the top 3,000 market capitalization-weighted U.S. stocks.

This chart plots the relationship between enterprise value (roughly, what it would cost to acquire the companies in this sector) and the free cash flow these companies generate. It is somewhat more objective than a price to earnings ratio in its ability to demonstrate value. **With inflation and interest rates at historically low levels, valuations should be well above the average and median of the past 25 years. But that is clearly not the case.** Although this chart is specific to technology, it is by no means unique. Indeed, valuation has remained subdued across most equity sectors.

The reason for subdued valuations can be understood in the context of the severity of the financial crisis and the slow pace of economic recovery. Although the cause is subject to debate, there is no disputing this recovery is sub-par. Each economic cycle shares similarities to past cycles but has characteristics which makes the cycle unique. This cycle began as a global recession and the recovery is powered by globally coordinated monetary policy. **Since monetary policy is characterized by imprecise lags between implementation and effect, it is likely that the impact of this easing will remain with us for quite some time, arguing for a longer, extended recovery.**

We have talked about the fundamental drivers of this cycle in the United States: easy monetary policy and the abundance of cash reserves, technology enabling productivity, an energy boom, a manufacturing renaissance based on efficiency and factory automation, and a recovery in housing which contributes to consumer confidence. **If the underlying fundamentals are not apparently robust, it seems investors have begun to believe they are at least sustainable.** In late June, as first quarter GDP was revised downward, for the third time, to the worst report since the first quarter of 2009, the market barely reacted. Realizing that the winter related slump was not reflective of fundamentals, markets rallied in the belief that there would be a weather related rebound on top of a return to normal economic activity.

Perhaps one of the major factors making investors anxious about stocks is that the U.S. market has gone more than two years without a correction greater than 10%. **While many think corrections are inevitable, it is very difficult (we think nearly impossible) to predict when they will occur.** A recent study by Laszlo Birinyi looked at 14 bull market corrections since 1982. This study provides an interesting perspective on corrections.

It seems there are relatively few events which trigger a stock market correction; the U.S. economy was partially blamed for eight out of fourteen. International economies were blamed for seven. U.S. politics caused four and the Federal Reserve Bank and interest rates caused five. Geopolitics and fundamentals were partially blamed for two and three corrections respectively.

There are two other noteworthy observations from Birinyi's study. This bull market has already had four declines greater than 10%, the most of the six bull markets he analyzed. **During any correction there is usually one particularly bad day which accounts for about a quarter of the entire decline.** This particularly bad day is more likely to occur toward the end of the correction, during the final month in half the observations.

Our strategy continues to stay with the primary trend, in this case an extended economic recovery. **Corrections, when they occur, come as a surprise and are relatively short lived.** By the time you realize you are in a correction, the market would be better to buy than to sell.

Fixed Income Market

The performance of the fixed income markets has been the biggest surprise during the first half of the year. At the end of 2013, bond investors universally believed that interest rates had nowhere to go but up, with a commensurate decline in price. On December 31, the benchmark ten year U.S. Treasury bond had a yield of 3.04%. By the end of the first quarter, the yield had declined to 2.73%, and by the end of the second quarter, the yield had further declined to 2.53%. These are big moves for bonds. It just shows that whenever the market agrees on anything, it is probably wrong. For the past many years, bonds and stocks have been negatively correlated; i.e. bond and stock prices move in opposite directions. That both asset classes turned in positive performance for the first half of the year is really quite unusual. **It would be easy to dismiss the strength in the U.S. Treasury bond market as a safe haven in a politically unsettled world, except that this tandem rise in stock and bond prices seems to have occurred on a global basis.**

In the early 1990s, when U.S. investors first began to look to international bonds to enhance portfolio yield, we were impressed by an analysis which de-constructed the returns from non-dollar denominated bonds. The study showed that returns from international fixed income investing derives from two sources, currency exchange and credit risk. **If you hedge away currency exchange you are left with a return commensurate with the default risk of the issuer.** A few years ago, as international bonds were perceived to provide superior returns, investors failed to appreciate the extent to which credit risk was being subsidized by currency exchange. In recent years, with a strengthening dollar and seriously stressed sovereign debt, the tide has turned and the focus is once again on credit risk. This became really apparent in mid June when the U.S. Supreme Court ruled against Argentina in a decade long battle with holdouts to a forced restructuring of Argentine debt. This ruling will have important ramifications for sovereign debt borrowers as well as creditors. It will be most interesting to see how this plays out in the debt markets in the weeks ahead.

For now, we still see higher long term interest rates and gradually rising inflation. We believe it is in our clients' best interest to use short maturity bonds to protect near term cash needs while waiting for higher rates. In the meantime we can all enjoy the bounty of rising stock prices.

International Market

Geopolitical concerns across the globe have frequented the headlines of mainstream media throughout the quarter. In Europe, the tension between Russia and the West over the sovereignty issue of Ukraine persists. In East Asia, China is having a territorial dispute with almost everyone else in the region. And, most notably, in the Middle East, the rise and rapid expansion of the Sunni Islamic insurgency, known as the Islamic State of Iraq and the Levant (ISIL), has caught many by surprise.

Even though ISIL has seized massive territories in the western and central regions of Iraq, the immediate impact on oil supply has been modest. Disruption affects about 150,000 barrels out of Iraq's current daily production of 3.25 million barrels, or approximately 5%. **However, given that the global oil supply is tight, the psychological impact of the potential for greater disruption of Iraqi production and export is enough to force European dependent Brent crude oil prices higher.**

As a consequence of this new chapter in the Sunni-Shia conflict, **Brent crude is trading at a nine-month high, exemplifying our European allies' heavy dependence on external energy resources.** This strategic weakness first became apparent when Russia, in a dispute with the West over the sovereignty of Ukraine, temporarily cut its natural gas supply, with the threat of permanently impairing supply.

Any disruption to energy supply could be disastrous, as high energy cost alone could force inflation expectations to increase. This could jeopardize the effective implementation of European stimulus policies, and stall economic recovery. Thus, governments are scrambling to retool their energy policies to avoid single-source dependence; this might have even inspired the Obama Administration to relax the 40-year restriction on the export of U.S. crude oil. **With the U.S. scheduled to become the top oil producing nation, we see the increased export potential for U.S. oil as a long-term positive.**

Switching the theater to East Asia, China's emergence as a global power has generated insecurity among its neighbors, especially as China mounts a campaign to control the South China Sea. This adds to worries in Washington over Beijing's aggressiveness in this energy-rich area. However, the tensions that China's actions have generated among its neighbors and the U.S. hardly seem to be in Beijing's best interest. **During this critical time as the country transforms from an export-driven and investment-led economy into an economy with private demand as the key driver for its growth, the ruling Communist Party needs to balance domestic needs with aggressive regional ambitions.**

It may be that China's expansionist policies are in part for domestic consumption, a distraction from domestic stresses. A "hard landing" for the Chinese economy has been a major theme among the bears of the investment community for some time. Despite the challenges, the Chinese government appears ready to introduce new expansionary measures whenever the country's growth target is in jeopardy. Since April, the Chinese government has introduced several new measures to encourage investment and stimulate growth. Fiscal accelerators, including investment in railway infrastructure, spending on public housing, and tax breaks for small businesses have been announced. The central government has even taken the unusual approach of urging local governments to speed up the implementation of their spending commitments. The Peoples' Bank of China, has used easy money tools such as injecting liquidity through weekly auctions and lowering the reserve requirement ratio twice within a two-month period to stimulate the economy. **After all, the main cause of China's growth slowdown in recent years has been the self-imposed restraints aimed at correcting long-term fundamental economic issues, and these policies are now being reversed.** The Chinese economy is much more resilient than many would perceive.

Despite dramatic headlines, markets have largely discounted these concerns and potential corrections have remained transitory. However, these events must continue to be closely monitored, lest they become significant impediments to the global recovery.

Our vision is to provide sound financial management for each client, always placing the best interests of the clients first. We aim to preserve and enhance every client's wealth while providing peace of mind and financial security, now and for future generations.