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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

Alan K. Chuang, CFA, CPA, CFP®, CIC
Portfolio Manager & Business Development Officer

Lily L. Ku, CFP®
Financial Planner

Devon M. Chan
Operations Manager

Joseph Fontamillas
Operations Manager

Spencer Chao
Operations Analyst

Cristina Palma, MBA
Operations Analyst

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 ~

"Year's end is neither an end nor a beginning but a going on, with all the wisdom that experience can instill in us." –Hal Borland

So True! In the world of investments, there is an unfortunate emphasis placed on calendar events. Month end, quarter end and year end have taken on an importance far greater than legal and tax deadlines would imply. Forecasts are presented for the coming year as though they have no connection to the old. But, as the quotation above implies, whatever happens in 2012 will be a continuation of the recent past.

In previous newsletters we have discussed the fundamental factors driving the markets this past year; the economy transitioning from recovery to slower secular growth, chronically high unemployment and artificially low interest rates, weather related supply chain disruptions, all under the cloud of dismay (and sometimes disgust) with inept (and sometimes corrupt) political leadership, whether in the Middle East, Europe, or the U.S.

Weighed down by pessimistic headlines, investors remained on the sidelines, relinquishing the stock market to algorithmic traders. These are computer programs which respond to headlines by electronically unleashing massive trading strategies. They have an instantaneous impact on the financial markets then, just as quickly, reverse direction, adding to the volatility and subtracting from the credibility of the financial markets. The inability of regulators to constrain these strategies produced a level of volatility unseen since the early 1930s; indeed, 40% of the trading days in August and September experienced more than a 2% price move.

Little wonder that investors turned cautious last year; but the timing and strategy may have been wrong. **It appears that the U.S. economy slowly continues to improve. Unemployment, while high, continues to decline. Manufacturing continues to contribute to the economic expansion.** Companies that had moved manufacturing out of the U.S. to take advantage of lower labor costs are increasingly bringing some of these operations back as logistics and skills shortages have produced fewer benefits than anticipated. Corporate profit margins (measured by earnings before interest and taxes to sales) continue to approach record levels while interest expense as a percent of profits is at a level not seen since the mid 1960's. **While earnings continued to move higher over the past year, prices did not.** This resulted in a lower price/earnings ratio and attractive valuations (compared to bond yields) which have not been seen since 1974.

This does not mean that the future is without risk for investors. Just because stocks are attractive does not mean they can't become more attractive. There is plenty of opportunity for grim headlines. **In the coming year, the potential for leadership change is on the agenda in four countries representing 40% of global GDP; Russia, China, France and the U.S.** Regime change is underway in Syria and the governments of Iran and North Korea are unstable.

The near term demise of the Euro seems to have been avoided, **but a European recession is forecast and a real solution is still in discussion**. In the U.S. the continued political posturing has created a series of short term "fixes" which has the unintended consequence of actually harming both business and consumer confidence. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 can charitably be called a work in progress. It was originally designed to avoid a redux of 2008, but still contains more than 90 provisions that require SEC rulemaking, including two that specifically address systematic risk, the reason it was originally proposed.

With so much political uncertainty, and no constraints on trading volatility, we think it is safe to presume that we are like the early explorers crossing the ocean in pursuit of wealth. The oceans may be choppy, at times; indeed stormy, and there are always head winds with which to contend. But, if we build sound ships, we will cross the ocean safely and return with wealth. **The portfolios we construct for you are sound.**

Fixed Income Market

In general, 2011 has been a good year for the fixed income asset class. **Given negative headline news dominating the domestic equity and international markets, fixed income assets have acted as a safe haven for those investors fearful of risk**. Even with the downgrade of the US credit rating below the coveted AAA level, US treasuries continued to be in high demand. There are two insights to be taken from that event. The first is that credit ratings continue to be only a starting point in any fixed income analysis. In our research for bonds, we use the credit rating grades only as a reference point for investment quality, but primarily rely on our research on the fundamentals of issuing entities to determine default risk. The second is that bond markets are strongly driven by supply and demand. Even with interest rates at all time lows and the 10 year Treasury yielding around 1.90% versus recent CPI numbers at 3.4%, it is demand that continues to keep prices high and yields low.

This demand trend on Treasuries is primarily the reason we have avoided purchasing them at these incredibly low yields. **At the same time, we have seen the spread between high quality corporate bonds and treasuries expand this year from around 150bps in the beginning of the year to around 239 bps in mid December.** Given the higher yields and our strong research process on corporate entities, we continue to buy high quality intermediate bonds in our client's portfolios.

Although we have used agency bonds in the past, the recent flight to safety in Treasuries has spilled over into the agency market. When looking at Federal Farm Credit or Federal Home Loan bank offerings, the yields have come down to 1.41% for five year bonds. **As an alternative to agency bonds, we have been buying in some accounts certificate of deposits traded on the secondary market.** The yields have exceeded agency bonds and with FDIC insurance, are very safe for those amounts less than $200,000.

For the municipal bond market, it has been about a year since Meredith Whitney made a dire prediction on "60 Minutes" that municipalities would suffer hundreds of billions in defaults. To the contrary the municipal bond market was one of the best performing for the year as investors sought the safety of public fixed income offerings. Additionally, state governments have attempted to address some of their fiscal challenges, for example, California passed a budget plan with automatic spending cuts if revenue doesn't meet projections. **As always it is important to thoroughly research all investment opportunities and we continue to seek out municipal bonds for our higher tax bracket clients**.

International Market

Looking back at 2011, Europe has occupied the center of the world stage. Headline news on government efforts to resolve their sovereign debt issue have sent markets around the world on a roller-coaster ride of volatility. **Global equity markets, including the U.S. market have seen unprecedented fluctuations this year. The only thing that seemed to matter to traders was policy news in the euro-zone, which determined the daily risk-on, risk-off decision**. A perfect example of this phenomenon occurred as recently as November. The world's largest economy, the United States, reported easing inflationary pressure, a faster economic growth estimate, higher consumer confidence, and a lower unemployment rate. Yet despite this series of stronger-than-forecast economic statistics, global markets still took a tumble because of negative news out of Europe.

This trend is increasingly frustrating to investors around the world and particularly for those in the U.S. In the U.S. market there are many highly profitable businesses with earnings at historical highs, large stores of cash and operating in an economy showing signs of improvement. Under normal circumstances, the improving economy alone would be pushing stock prices of the profitable companies higher, but they haven't because Europe is overshadowing the good news. **Investors continue to sit idly by as they wait to see what happens in Europe. It is logical to say that global equities will remain stagnant until European issues start to get resolved**.

Since the most recent European summit concluded in mid-December, markets are increasingly optimistic that European governments are moving in the right direction. The ECB, with the help of the IMF and other central banks, have finally stepped up and are now acting as a quasi "lender of last resort" in addressing short-term liquidity concerns. In addition, governments are examining the cause of turmoil and discussing a long-term solution. The principles of a new "fiscal compact" among euro-nations have already been agreed upon. After ratification by each country's parliament, this fiscal accord will serve as a constraint on every country to live within its means. **For Europe to fully resolve its issues will no doubt take time and the question remains whether the euro-zone will remain in its current form, if at all. Nevertheless, after a prolonged period of trial-and-error, markets are gaining a greater clarity on how future crises will be handled and the sovereign debt issue will eventually recede and markets will return to normal.**

In addition to Europe, equity performance from Asian markets, in particular the Chinese market has been unsatisfactory this past year. However, the situation should improve in the coming year. **Asia's ten biggest economies excluding Japan have grown at an average of 5.2 percent in the most recent quarter and the IMF is expecting the region's developing economies to expand at 8 percent in 2012.** Most governments in the region have the fiscal leeway to enact further stimulus measures if necessary, not only because government debt levels are relatively low but also because their central banks are holding $5.2 trillion in currency reserves, more than half the total global reserve of $10.2 trillion. Additionally, with early signs that the Chinese government is starting to ease the grip it has placed on economic growth, there is hope this region's equity markets will recover.

2011 has been a challenging year for international markets but with signs of positive developments becoming more apparent, we are cautiously optimistic looking forward to 2012. We agree with Bloomberg's recent Global Poll, which indicates that besides the U.S., Brazil and China are the two top-rated markets for 2012. **We have positioned our clients' portfolios accordingly, based on our positive view for both the Asian and Latin American regions. However, we still advise caution when looking at European investments.**