

## ~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

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We wish all of you a healthy and prosperous New Year. Last year's stock market returns were better than those of any year since 1997. While we remain positive about the prospects for the coming year, it is difficult to imagine 2014 providing significantly better performance than that of the past year. During 2013, the economy continued to grow, picking up momentum as the year progressed. This was in spite of dysfunctional, sometimes corrupt governments and ineffective, burdensome regulatory policies, both here and abroad. In other words, over the past year, the stock market climbed the proverbial "wall of worry" to deliver superb returns.

The continued recovery in the U.S. has been aided by the easy monetary policy of the Federal Reserve Bank. **As the economic recovery has progressed in the U.S., central banks on a global basis have shifted from policies promoting austerity to aggressive monetary easing.** The results are becoming increasingly evident, particularly in Europe and Japan, as economic activity and stock prices are beginning to improve.

In the U.S., monetary easing has aided a nascent housing recovery, which in turn has buoyed consumer confidence. But the recovery here is more than simply a monetary phenomenon. The U.S. has made significant progress toward energy independence, insulating us from the political turmoil in the Middle East, and bringing stability and lower prices for a primary industrial feedstock. **In the aftermath of the financial crisis, U.S. companies have become increasingly efficient, with productivity surpassing previous levels.** This translates into a prosperous private sector, which we expect to continue to drive economic growth in the new year. Also, with midterm elections looming in the U.S. in 2014, we should see government policies posing less of an obstacle to growth than in recent years.

With better visibility for future profits, the stock market appreciation of the past year should not have been a surprise. Apparently, equity investors understand "tapering," the scaling back of quantitative easing, as additional evidence of a strengthening and increasingly self-sustaining economy. **It is also wise to remember that "tapering" is still easing, not tightening, of monetary policy.**

When stock market investors buy stocks, they buy a participation in a future stream of cash flows produced by the underlying companies. It stands to reason that investors are willing to pay more for the

increased visibility of this future. Last year, the stocks in the S&P 500 grew their earnings at a 10-12% rate. **Not bad, but the market price appreciation was considerably greater, driven by the belief that this growth will continue into the foreseeable future.** We agree.

During the fall of 2013, the CFA Institute polled its membership and produced the "Global Market Sentiment Survey" for 2014. While the survey is quite detailed and rigorous, we will share a few of the highlights with you. If you would like to view the report in its entirety, please contact us and we will provide the link:

- **Sixty-three percent of the members responding to the survey expect the global economy to expand in 2014 compared to 40% last year. Members in the U.K. are most optimistic (78%), while members in China are most cautious (48% expect expansion).**
- **Seventy-one percent identified equities as the asset class most likely to perform best, compared to 50% in 2013. The U.S. and China are considered to hold the best investment opportunity, followed by Japan and Germany.**
- **Sixty-eight percent of members worldwide are concerned that the prospect of central banks ending quantitative easing will have a negative impact on their local market in 2014. Concern was especially high in Brazil and India.**
- **Noted sources of uncertainty in local markets were weak economic conditions, political instability and excess regulation. Political instability was noted as of particular concern in India, South Africa, Brazil and the U.S., all countries gearing up for important elections in the coming year.**

We included these highlights in our newsletter because, generally, they mirror our thinking on various economies and asset classes. **Although we agree with the respondents to the survey, it does concern us when such a large majority expects the global economy to expand in 2014, and an even larger percentage expects equities to be the best performing asset class.** We understand the reasoning but we would feel more comfortable if these views were less widely shared. When investing, we never find comfort in the consensus.

## Fixed Income Market

On December 18<sup>th</sup>, the Federal Reserve completed its final meeting for the year. In what was a surprise move to some, the Fed decided to reduce its monthly bond purchasing program by \$10 billion. The \$10B will be equally trimmed from purchases of mortgage backed securities and Treasuries. Although the 10-year Treasury rate was relatively unchanged at the end of the day on the news announcement, it has since crept up toward 3% as of year-end. **Many expect the tapering to continue and the 10-year Treasury yield to reach 3.5% in 2014.**

As we've discussed in the past, a tapering of the Quantitative Easing (QE) program is not only expected but desirable from our standpoint. It points to an improving economy where we've seen the inflation rate remain below 2%, the unemployment rate decline to 7%, and GDP increase to an annualized rate of 4.1% for the 3<sup>rd</sup> quarter despite a 16-day government shutdown. However, the Fed feels the economy still "has much farther to travel before conditions can be judged normal" and has kept the Fed funds rate target at zero. **Going forward, Fed President Jeffrey Lacker stated that the market should expect \$10 billion in reductions as a baseline for future stimulus decreases with adjustments dependent on economic data.**

It was a difficult year for fixed income investments. The long-end of the Treasury market had one of its worst yearly performance results, losing 12.7%. The bond market as a whole returned -1.85% and municipals returned -3.47%, largely due to the long-end nature of the index and the high profile default of Detroit. Several other factors contributed to the decline in the bond market including the anticipation of QE tapering and resulting rising rates. We also saw a transition of mutual fund flows from bond funds to equity funds given the strong performance of the stock market this year. December marked the 6<sup>th</sup> consecutive month of net outflows from fixed income funds. **Keep in mind we invest in shorter maturity bonds and hold our bonds to maturity; the negative performance of the broader bond market have not affected the safety of principal in our client portfolios.**

We still look to the corporate bond market where we see the best yield to risk opportunities, as corporate balance sheets continue to improve. The Fed recently released the Flow of Funds report which listed nonfinancial corporate cash (all companies except banks) at a record \$1.9 Trillion. Further digging into the numbers, it appears many companies have refinanced or pushed out short term debt and are now sitting on large cash balances with few short term liabilities. This bodes well for the safety of corporate bonds but has also led to an increase in ownership of the corporate bond asset class which stood at a recent high of 17.4% of all outstanding bonds. **Given this higher allocation there could be some volatility in corporate bond prices as interest rates move up next year.** We will continue to monitor the situation, but again take comfort from the shorter maturities of your bond holdings.

## International Market

The considerable volatility in emerging markets over the past year has had a negative effect on investor sentiment. Uncertainty, over the local impact of the U.S. tapering of quantitative easing, depreciation of local currencies versus the U.S. dollar, and muted economic growth relative to past years, has reduced emerging market returns. The environment for most emerging markets remains challenging, mostly due to rising inflation. **For China, however, much of the recent turbulence was caused by a market focus on short-term factors rather than an appreciation of long-term drivers of growth.** Hence, China represents an opportunity for future investment returns.

The slowing of China's high growth rate has been a major concern for investors, but maintaining a growth rate greater than 10 percent is unsustainable in the long-run. Since President Xi Jiping and China's other new leaders took power in March, they have focused on adjusting the country's policy priorities toward growth *quality* rather than *quantity*. **This policy shift has led to sacrificing short term growth in exchange for an emphasis on sustainable growth and protection from financial risk.**

Initiatives are being introduced to transform an economy from heavy dependence on industrial output to a service orientation. For example, to free up commercial activities, financial liberalization reforms in the Shanghai free trade zone are soon to be implemented. These policies will become the model for other free trade zones in China. No less important, China is revising the country's securities laws to allow the government to implement the ambitious financial reform goals approved by its new leaders. The legal changes include plans to move initial public offerings from an approval-based system to a registration system, similar to the U.S., along with laws on mergers and acquisitions, corporate restructuring, and investor protection. This reform blueprint signals a shift to a market-based system where regulators focus on information disclosure and leave judgments of risk and profit potential to investors. **If implemented successfully, it will be a gigantic leap for the Chinese financial market toward becoming one of the dominant global markets.**

Despite the reforms in progress, China's highly leveraged and vulnerable financial system, along with bloated real estate prices, still remains a challenge for the Chinese government and poses a real threat to its economy. To help curb the growth in housing prices and send a message to banks to de-leverage their balance sheets, the Chinese central bank is believed to have engineered two cash crunches in China's money markets in June and December of 2013. The People's Bank of China (PBOC) typically auctions repurchase or reverse-repurchase agreements on Tuesdays and Thursdays to manage the money supply in the financial system. By refraining from offering auctions, the money supply in circulation was dramatically reduced, which ratcheted up the interbank rate. This made it extremely difficult for the smaller regional banks, dependent on interbank lending, to operate. **Since the purpose of these strategies was to maintain an orderly market, investors should not overreact to the resulting short-term market volatility.** Premier Li Keqiang has pledged that the government will keep liquidity at an appropriate level in 2014 to maintain the stability of financial markets and the broader economy.

While we have focused on China in this article, we also see opportunity in other emerging markets. However, given the unsettled state of the current environment, we are just beginning to re-establish positions in China. We think it may be too early to fully invest in other emerging markets due to concerns regarding inflation and its erosion of local currencies. Certainly, as investment opportunities in other developing markets become sufficiently attractive, we will again participate in these regions. **We remain comfortable with over-weighting developed markets while under-weighting emerging markets.**

While the situation in emerging economies appears less promising, the once troubled Europe and Japan, stalled for more than a decade, seem to have weathered the decline and are beginning to show evidence of renewed growth. **Thus, for now, we are comfortable over-weighting developed markets while under-weighting emerging markets.** However, with China starting to show early signs of stabilization, it is only a matter of time until investment opportunities in the developing world become sufficiently attractive to again participate in emerging markets.

*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.*