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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

With global financial markets in a swoon, investors are left wondering what happened. The newspapers are full of articles describing various aspects of the financial turmoil that have characterized the past six months. While most of these articles describe the situation, they fail to provide perspective for the average investor. We will try to provide this perspective in the next few paragraphs.

There are three principles which define the current environment. The first originated with Professor Hyman Minsky, who spent his life trying to understand financial cycles. His life work can be understood by the notion that **stability begets instability**. That is, when the economy appears stable, investors extrapolate that stability into the future and take actions, for example borrowing to leverage their returns, that then leads to instability.

The second principle is that **money or liquidity is the primary driver of economic growth**. Years ago, when I studied economics, we were taught the magic of fractional reserve banking. That is, when you deposit funds at a bank, it doesn't sit on a shelf; rather the bank loans the money and it is circulated and re-circulated in a calculation described as a multiplier. It is this liquidity which drives the economy and, in the past, could be regulated by the government setting capitalization and reserve requirements.

During the past thirty years, financial technology has evolved. Especially **during the decade of the nineties, the financial system was deregulated, giving rise to what has been called a "shadow banking system."** This market is huge, unregulated, and highly leveraged. Since this market is largely based on private transactions, it is not transparent.

Because of these characteristics, **liquidity is determined by confidence.** A borrower needs confidence that they can invest borrowed funds to make a profit, and a lender needs confidence that the borrower will have the resources to repay the loan. During the past decade, with real estate prices rising, there was no shortage of confidence or liquidity. The pool of liquidity met and exceeded demand, pushing housing prices higher. **When real estate prices stopped rising, the extent of the leverage cast a pall of doubt over the value of the collateral. With this loss of confidence, liquidity began to shrink dramatically.**

As shrinking liquidity began to threaten the broader economy, the Federal Reserve Bank moved to restore confidence. **This proactive and aggressive role the Fed has undertaken recently should bring stability to the financial markets.**

This brings us to the third and final principle in understanding the current environment, the power of the Federal Reserve. **The Fed has the responsibility and authority to defend the dollar, and to protect and maintain the integrity of the banking system.** Under Chairman Bernanke, the Fed has shown a willingness to take this responsibility seriously. During the recent market turbulence, the Fed assumed a particularly aggressive role. The old maxim "Don't fight the Fed" has renewed relevance today. **As confidence is restored, liquidity will again expand, stimulating economic growth.** Long before we see evidence of an economic expansion, the financial markets will rally.

Ripple or Tsunami?

Modern technology enables information to flow freely and instantaneously; hence, the world is a much smaller place. **Markets around the world are all influenced, to a different degree, by events happening elsewhere.** Free flow of capital and assets between countries also make economies more interrelated than ever before. Therefore, some of the issues we used to consider as domestic are having an impact on economies globally.

Slow U.S. economic growth, a weak U.S. dollar, and the debacle caused by U.S. sub-prime meltdown are no longer U.S. specific problems; what affects the domestic U.S. economy has an impact on every economy on the planet. In addition, because most commodities are traded globally and priced in dollars, the weak dollar causes commodity prices to skyrocket. With this in mind, **we currently favor countries and regions that have diversified their dependence away from trade with the U.S, that do not have extensive exposure to U.S. sub-prime debt, and are rich in cash flow generating natural resources.**

We believe that countries are unique; each country has a distinct competitive advantage that drives its economic growth. If we can identify those companies, within a country or region, that capture the growth advantage of the region, we can achieve international exposure while participating in companies and economic sectors that are likely to outperform on a global basis.

By using carefully selected ADRs (American Depositary Receipts), we can focus on those companies which enjoy a comparative advantage while avoiding those companies which lack advantage but may represent the bulk of the market capitalization in a given economy. Also, by using ADRs, we can be more precise in building economic sector diversification into your overall portfolio structure.

International investing is still very important, both for geographical diversification and to seek excess return. Although markets are no longer isolated from each other, a portfolio which holds both international equities and U.S. equities should be less volatile while producing higher returns.

Flight to Quality

Fixed income investments are used in a balanced portfolio to provide current income and increase portfolio stability. Not only are bonds generally less volatile than common stocks, their prices often move in the opposite direction as that of stocks, dampening overall portfolio volatility even more. **At Pillar Pacific Capital Management, we emphasize high quality, intermediate-maturity securities, and make investments appropriate to each client's tax situation.**

Recently, some parts of the bond market have been in a crisis mode, with a major "flight to quality" occurring. Many bond investors have sold riskier mortgage-backed bonds and those of financial companies, and bought U.S. Treasury securities.

The flight to quality has caused the prices of U.S. Treasury bonds to be bid up to very expensive levels, while other good-quality bonds have lagged behind. This has created some investment opportunities. One such opportunity is in bonds issued by U.S. government agencies, where the yields relative to U.S. Treasuries have widened considerably since the middle of last year. Agency bonds that can be called before their maturity date have even higher yields relative to Treasuries.

Another opportunity is in higher-quality corporate bonds, including some of the industrial names and top-quality finance names like General Electric Capital. Yields have increased dramatically on these bonds relative to Treasuries.

Some inflation-protected bonds may make sense right now, as well. The Treasury Inflation Protected Securities (TIPS) issued by the U.S. Treasury have become expensive along with all other Treasury bonds after performing extremely well over the last few months. However, there are some corporate bonds issued recently with interest rates that adjust with the Consumer Price Index. Their yields are substantially higher than those of TIPS.

For clients in medium and high tax brackets, good-quality tax-exempt municipal bonds represent one of the best relative yield opportunities in years. Pre-tax yields on Muni bonds are actually higher than those on Treasury bonds, a situation that rarely occurs, and after-tax yields are of course much higher.

In all areas, **we are buying fairly short maturities, since the simulative monetary policy of the Federal Reserve may increase the chance of inflation and higher interest rates later on.** At that point, we may be able to lock in higher rates by buying somewhat longer-maturity bonds.

Facts on Tax Rebate Check

The IRS has announced that it will start sending the economic stimulus tax rebate checks starting on May 2.

For extension filers, to ensure you receive your stimulus payment this year, the IRS requires you must file a tax return by Oct. 15.

Basic Eligibility

The IRS will use the 2007 tax return to determine eligibility and calculate the basic amount of the payment. In most cases, the payment will equal the amount of tax liability on the return with a maximum amount of $600 for individuals ($1,200 for taxpayers who file a joint return) and a minimum of $300 for individuals ($600 for taxpayers who file a joint return).

Even those who have little or no tax liability may qualify for a minimum payment of $300 ($600 if filing a joint return) if their tax return reflects $3,000 or more in qualifying income.

Phase Out: The stimulus payment begins to phase out for individuals with adjusted gross incomes (AGI) over $75,000 and married couples who file a joint return with AGI over $150,000. The combined payment is reduced by 5 percent of the income above the AGI thresholds.

Here are two examples of how the phase out works:

- An individual with AGI of $100,000 with tax liability qualify for a basic rebate of $600. But because the individual's AGI exceeds $75,000, the rebate is reduced more than $600 (($100,000 - $75,000)x5%). The individual receives no rebate check.

- A married couple with two children, AGI of $160,000 with tax liability qualifies for a basic rebate of $1,200 and an additional qualifying child credit of $600 for a total rebate of $1,800. But because the couple's AGI exceeds $150,000, their rebate is reduced by $500 (($160,000-$150,000) X 5%). The couple receives a rebate check of $1,300.

Will I Have to Pay Taxes On My Rebate?

According to the IRS, you will not owe taxes on your rebate when you file your 2008 income tax return. However, you should keep a copy of the IRS letter you receive later this year listing the amount of your payment. In the event you do not qualify for the full amount this year but you do next year, you will need to have the letter as a record of the amount you previously received.

In addition, your tax rebate will not reduce your refund or increase the amount you owe when you file your 2008 tax return.

What is the age limitation for the extra $300 child payment?

Eligible taxpayers who qualify for a payment may receive an additional $300 for each qualifying child. But to qualify, a child must be under age 17 as of Dec. 31, 2007.

In Summary, you won't get a stimulus payment in 2008, if any of the following apply to you:

- You don't file a 2007 tax return.
- Your net income tax liability is zero and your qualifying income is less than $3,000. To determine your qualifying income, add together your wages, net self-employment income, nontaxable combat pay, Social Security benefits, certain Railroad Retirement benefits and certain veterans' payments.
- You can be claimed as a dependent on someone else's return. For example, this would include a child or student who can be claimed on a parent's return.
- You do not have a valid Social Security Number.
- You are a nonresident alien.
- You file Form 1040NR or Form 1040NR-EZ, Form 1040PR or Form 1040SS for 2007.

~ Source from: IRS news release IR-2008-44 , March 17, 2008
~ Please consult with your tax preparation professionals

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.