PILLAR PACIFIC CAPITAL MANAGEMENT, LLC

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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

With the stock market up substantially from March lows and the economic decline beginning to stabilize, we thought it would be useful to review some of the lessons we have learned in this recent financial crisis, and how it might set the stage for subsequent recovery.

Perhaps the single most important lesson is that monetary policy, which has been used by central banks to control economic activity for the past several decades, is only effective if there is a functioning banking system. The underlying financial health of banks depends on confidence and trust. It was not the bursting of the housing bubble, per se, that doomed the economy. Rather, the broader economy began to shut down when banks ceased their lending for fear that other banks were over leveraged to housing. Once confidence and trust are lost, the economy will begin in a downward spiral that is very difficult to reverse.

In the past couple of decades, with globalization, **the world has become interconnected.** During this recent financial crisis it became clear just how interconnected we had become. As we have pointed out in prior newsletters, as painful as the decline was in the U.S., it has been worse in much of the rest of the world.

It is the extent of this interconnectivity which amplified the housing bubble in the U.S. into a global financial crisis. **However, even in an environment where almost every asset class experienced a decline, the value of diversification was apparent**. During the fall quarter, liquidity in the bond market all but disappeared, while stocks could still be bought and sold. Because of this asset class diversification, portfolio liquidity was maintained and market volatility was dampened.

Many of the tactical lessons were reminders of basic principles we have learned over the years. Avoid leverage and companies reliant on leverage during a period of tight money. **Hold your positions, if they are sound, when markets are discounting the end of the world.** Psychological extremes in market sentiment represent opportunity. Avoid being victimized by the "endowment effect", because you paid more for a stock in a robust market environment does not mean that it will return to that level, even when the market recovers. There may be investment opportunities lost, and opportunity costs, while you wait for a stock to discount a future that is no longer probable. Long-term goals and objectives should not change with market sentiment. **A long term investment horizon helps to maintain objectivity and should drive asset allocation decisions. Finally, a disciplined investment process helps to maintain the objectivity to weather the darkest days of a financial and market crisis**.

An aspect of the "endowment effect" poses another risk to investors. Too often we hear the question, "How are you going to prevent this happening next time?" We are always trying to build a Maginot line to prevent the last disaster. We understand human nature is molded by adaptive expectations; that our behavior reflects our most recent experiences. Last November, the market hit a significant low, rallied, and then hit a new low in early March. Investor sentiment was dismal with much regret that stocks had not been sold at year-end. But while we were busy wallowing in shock and self pity, **stocks have appreciated substantially since early March .** It would have been easy to sell our positions and miss the easy returns of a nascent market recovery.

In the beginning, we discussed the need for a functional banking system for central banks to implement effective monetary policy. With the freeze of the banking system, last year, there was no multiplier for the central banks' conventional stimulus policies. Vast amounts of liquidity have been provided, but without a healthy banking system, these funds were hoarded. **As the health of the banking system is restored these funds should once again begin circulating, creating a multiplier effect that will produce sufficient liquidity to restore global economic growth.**

Right now, the consensus view is that the economy will recover slowly, stabilizing over the coming months, beginning to recover in the fall, and continuing to grow at slower than normal recovery growth rates well into 2010. **We believe that the wildcard to this scenario is that the liquidity already in the system, multiplied by a restored banking system and further fueled by government fiscal stimulus programs, could produce an above consensus economic expansion.**

The antithesis to this forecast is the potential amount of deficit financing on the part of the U. S. Government. Early in the 1980s, the last time the United States found itself in such a situation, the concept of "crowding out" was used to describe the competition for available funds. As long maturity U. S. Treasury yields rose to the mid-teens, corporate borrowers had difficulty competing to raise affordable capital in the debt markets. **This time, the fear of crowding out has raised a howl of protest from Beijing to Berlin.**

In early March, money market fund reserves, earmarked for equities, stood at record levels as the stock market hit its nadir. Since then, roughly 25% of these reserves have been redeployed into stocks, driving the broad market averages up 36%. So far, every pullback in the stock market has been used as a buying opportunity. We expect this to continue, albeit at a slower pace. In the months ahead, stocks will begin to anticipate the unique characteristics of the next economic cycle. **We think our portfolios are well prepared.**

Fixed Income Update

The bond markets have begun to thaw and return to more normal trading conditions, as recovery from the financial crisis of 2008 continues.

In the recent quarter, yields on U.S. Treasury bonds increased from their very low levels at year-end. The Treasury has been issuing unprecedented amounts of new bonds to finance the government stimulus plans that have been put in place, and this supply has outpaced demand in the near term. **Bond investors have also grown increasingly concerned about the ultimate impact of large government stimulus on future inflation.**

While Treasury bond rates were increasing, yields on corporate bonds rose only slightly, and **yields on the bonds of financial companies actually declined during the period as investors became more comfortable with the prospects for these companies**.

Yields on tax-exempt municipal bonds also declined for much of the quarter, however they moved back up in June as municipal issuers used the better environment to come to the market with a flood of new bond issuance that had been postponed during the worst of the financial crisis. **Continued negative news about the financial picture for many states and municipalities also caused investors to demand higher yields**.

We continue to find good value in high-quality corporate bonds. The spread between their yields and those on Treasury bonds remain fairly high even after the narrowing that has taken place this year. Although tax-exempt bonds also offer relatively attractive after-tax yields, it is important to focus on the financial strength of the issuers in a difficult environment for state and local governments.

Investors have begun to price some inflation into their forecasts**, but we would continue to be cautious and focus our buying on short and intermediate maturities.** Treasury Inflation Protected Securities (TIPS) also offer some protection in the event that inflation begins increase.

International Market

International stock markets have rebounded nicely in the last quarter. Yet despite the growing sense that the worst is behind us both domestically and abroad, each country still faces its own set of challenges, with some presenting more opportunity than others. The developed countries like the U.K. and Japan are recovering; however, **the greatest optimism seems reserved for the larger emerging markets such as the BRIC countries, Brazil, Russia, India, and China.**

Brazil, will hold a presidential election in 2010 which leaves some uncertainty as the current popular president Lula retires after his second four-year term. Despite having a rigid labor market and poor education system, **Brazil has posted a quarter to date return of 41% as the stock market focuses on the positives in Brazil**. Industrial production continues to rise with its fourth consecutive monthly increase. Vehicle production, for example, was up 6.7% in May due to lower prices and increased availability of credit. Banks have also extended loan periods for car payments and the credit card business is growing. Additionally, the tough regulatory system has kept Brazil's banks healthy and free from risky assets, while low mortgage availability prevented housing from overvaluation. Brazil now has 50million out of 190million residents considered middle class with incomes over $5,000 per year. This has all lead to increased foreign investor interest looking for a country with stability and growth.

Russia has also experienced a strong rally with a quarter to date return of 49%. But, having recovered off its lows, Russia does not look as undervalued and continues to face many challenging macro issues. The Russian President Dmitry Medvedev has predicted the economy will contract by at least 6% this year leading to its first recession in a decade. Unemployment continues to rise which in turn hinders consumer demand and many companies still have burdensome levels of corporate debt. In the end, **the Russian market continues to be very volatile due to its higher political risk and lack of corporate transparency.**

In India, there has been newfound optimism with the election of Prime Minister Manmohan Singh. Prime Minister Singh's Congress Party has been a strong advocate of free-market reforms and increased spending on infrastructure and public services. On the Election Day the Indian market jumped 17% and has posted a quarter to date return of 51%. **The new government is expected to overhaul labor laws; allow more foreign direct investment; divest assets in state-owned companies; develop a corporate bond market; and spend on improving transportation infrastructure**. But these types of major initiatives take time to implement and the recent global recession has almost halved India's economic growth. Nevertheless with domestic consumption still rising and low dependency on exports, India is still expected to grow at 6% this year.

Finally, in China, industrial production has started to recover, and imports of commodities have risen. The Chinese market has increased 35% quarter to date. Although exports are still struggling, China has seen an increase in consumer purchases as the $586 billion stimulus spending is starting to take effect. Consider the impact of the $1.02 billion government subsidy for people in rural areas for cars and home appliances. That led to a 25% increase year over year in car sales in April and a 14.8% increase in retail sales. **In fact it seems that domestic consumption may be the primary driver of the economy going forward and will hopefully help China meet its goal of 8% growth this year.**

We continue to see opportunities in countries like Brazil, India, and China not only in their diversification characteristics, but also in their growth potential. Yet it is always important to remember that these markets are very volatile and continue to struggle with transparency and political risk. Additionally, the massive deficit financing by the US will possibly lead to a global "crowding out" effect where other foreign countries seeking to finance their stimulus through debt financing, may see higher costs and reduced appetite for their debt. Nevertheless**, we are continually researching stock candidates for you and selectively including them in your portfolio where appropriate**.