Quarterly Newsletter

PILLAR PACIFIC CAPITAL MANAGEMENT, LLC

Volume XII, Issue 3 October 2008

Mindy L. Ying, MBA
President & CEO

Arthur T. French, CFA, CIC
Chief Investment Officer

Craig A. MacLeod
Chief Operating Officer & Chief Compliance Officer

Mark A. Keeling, CFA, CIC
Senior Portfolio Manager

Sonny C. Lin, CFA
Senior Portfolio Manager

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

Adrian C. Moravcsik, CFA
Director of Business Development

Lily L. Ku, CFP®
Financial Planner

Jinny Brown
Relationship Manager

Hongmin Lu, CFA
Compliance Officer & Quantitative Analyst

Michael C. Yu
Operations Manager

Devon M. Chan
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 ~

The current financial crisis can seem very complicated at times. Simply, as interest rates declined in recent years, investors wanted to increase their returns. The market accommodated by providing fixed income instruments based on real estate. Since the value of homes had been rising for years, the value of the collateral seemed secure. In time, these secure investments were used as collateral to borrow money in order to leverage the returns. As long as housing prices were rising, the leveraging of this asset base continued until there was no longer a margin for error. The decline in housing prices triggered massive losses in the financial markets, as well as a reluctance to lend based on the uncertain value of the various layers of collateralized debt.

The problem was exacerbated by two structural developments in the financial markets: the rapid growth of hedge funds and the even more rapid growth of a derivatives market called swaps. Neither is regulated and neither is transparent, and both have the resources and leverage to bring down the system.

Swaps started out as a form of insurance between counterparties. Swaps have been around since the 1970s and serve as a useful tool for financial companies to hedge their inventories. They are dependent on an assessment of counterparty risk and the ability to pay. The better a firm's financial strength and credit rating, the better its position as counterparty in the swap market.

The insurer American International Group (AIG) moved into the swaps business. They sold complex financial contracts called "credit default swaps" based on AIG's solid credit rating and strong balance sheet. Somehow, it got out of control. With the failure of Lehman Brothers as a catalyst, the extent of AIG's exposure to default was revealed and it was staggering. The largest private insurer in the world, operating in 130 countries and employing 116,000 employees, was forced to seek help from the Federal Reserve Bank due to imprudent risks assumed by the 377 employees operating out of a small London office. Where were the internal controls and where were the regulators?

In the past twenty years, hedge funds have morphed from small investment pools serving private wealth investors to multi-billion dollar pools investing institutional assets. With the use of leverage, they control trillions of dollars of market value. Due to legal technicalities, there are few constraints on their activities and virtually no transparency. Their influence has been profound. Attempts to rein them in have been unsuccessful. When existing laws stand in the way of profitable trading strategies, it is usually the laws which are changed. It is not fair to paint all hedge funds as evil since they take many different forms. But they have been given significant advantage and some have used that advantage to generate profits from predatory trading strategies. Some are finally being investigated to see if these strategies qualify as criminal price manipulation.

The theme we are trying to develop here is that economics can not be considered without a recognition that it is a part of a greater political system. George Friedman of Stratfor (www.stratfor.com) describes this in a piece titled "The Political Nature of the Economic Crisis". As the title suggests, "Economics is not a freestanding discipline…It is a discipline that can only be understood when linked to politics, …since economics makes significant assumptions about both human nature and proper behavior."

In their "Weekly Update on the U.S. Economy and Financial Markets", the University of Pennsylvania economists Lawrence Klein and Wendy Mak note: "The lack of plausible policy action has allowed a massive market failure that is imposing unnecessary poor performance on the macro economy and some degree of international contagion." It is time for our elected and appointed government officials to show leadership. Beyond infusions of taxpayer money, we need transparency and regulatory scrutiny of investment schemes that are fully capable of damaging the entire financial system.

… continued on page 2

… continued from page 1

Most of the time, investors are in competition to buy stocks which are very efficiently priced. In the current environment, with fear palpable, investors have an opportunity to own stocks at a significant discount to where they will be in the next three to five years. In spite of the chaos that seems to characterize the financial markets, there are stocks of good companies that represent good economic value. We are actively taking advantage of these opportunities in the marketplace. While market volatility is unnerving, we have no doubt that we will get through the current crisis, and your portfolio will fully participate in both the market and economic recovery.

Fixed Income Update

The bond market re-entered crisis mode during the third quarter as investors sought the shelter of U.S. Treasury bonds and worried about everything else. Treasury securities were therefore the best-performing part of the bond market, and government agency bonds also did relatively well. Corporate bonds suffered the most, particularly in the financial sector, as concerns mounted over the health of the financial system. Tax-exempt bond prices gave up a little ground, but coupon interest income generally offset the price decreases.

The continued rally in Treasury bonds has pushed yields down toward levels last seen in 2003. While the desire for safety is understandable, future returns from these levels will be low. Thus, we believe it continues to make sense to diversify holdings across all sectors while staying with higher-quality issuers.

For example, U.S. government agency bonds continue to offer yields higher than Treasuries, while retaining the backing of the federal government. Bonds of high quality industrial issuers are also a good relative value. While yields on bonds of financial companies are the highest available right now, we would be cautious about further purchases here until the situation in the financial markets becomes clearer.

Tax-exempt municipal bonds also continue to offer relatively higher yields for taxable investors. Again, we would stick with the highest-quality, more liquid issuers and not reach for yield in lower quality bonds. An economic slowdown may create problems for municipalities that are not in a strong financial position.

International Market Update

The financial crisis in the United States has spilled over to nearly every other global market. With the assistance of government intervention, we have confidence the crisis will be contained and we will emerge from this difficult period. The impact on global markets, however, is inescapable.

So far, Europe seems to have been most affected and will probably take longer to recover. As the European economy continues to contract, and confidence wanes, we see no plausible cohesive strategy to address the crisis. Since the countries forming the European Union share the same monetary system and policy, the efforts of individual government policies are ineffective and will remain so until they can devise a unified strategy. Additionally, unlike the realistic and massive losses already taken by U.S. financial institutions, European banks and insurance companies have been slow to write down their troubled assets to reasonable levels. As the recent weakness of the Euro would indicate, there is much to be done before Europe can begin to stabilize.

Latin America's fastest economic expansion in 30 years has begun to slow, as the credit crunch strangles investment and shrinks demand for the region's export commodities. However, since the region's exports serve basic needs in some of the most rapidly growing regions in the world, we think demand will recover, quickly. Also, the current slowdown may be milder than previous crises, since many regional governments have used revenue from the commodity boom to pay down debt and build capital reserves. Since Latin America's economy is closely correlated to the U.S. economy, once we see a U.S. recovery, Latin America will follow.

The impact on Asian countries seems relatively minor in spite of the Chinese market experiencing one of the deepest declines in the region. The primary cause of the Chinese stock market correction was simply that it had reached unsustainable valuation levels after a long period of significant out performance. When the Chinese government intentionally slowed economic growth, it was a sufficient catalyst to rein in the overheated market. With reports out of China indicating inflation pressure has subsided, we see the potential for economic activity to accelerate. We also think Asian banks have lower exposure to troubled U.S. debt obligations; when confidence is finally restored, these banks should come out of this stronger and more competitive.

In this complex and volatile global marketplace, our strategy continues to utilize fundamentally solid ADRs to enhance the performance of your portfolio.

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.