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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

In our last newsletter, we described changes which have taken place in the capital markets due to the unprecedented impact of quantitative easing combined with a profound restructuring of the financial system through regulations such as the Dodd-Frank Act. We concluded that the market pricing mechanism of financial assets has been impaired. No longer are short term fixed income prices determined in the market place; they are set by the central banks. Trading liquidity has been drained from the market through regulatory pressure to end proprietary trading. This has deprived the markets of reference pricing: i.e. if you don't know the price of money, you don't know the price of anything.

The result is a market environment of increased individual stock correlations, where stocks tend to move together, and reduced price dispersion, where individual stock price moves do not value differences in company fundamentals. This period of lower dispersion and higher correlation of returns roughly coincides with the implementation of quantitative easing.

A rising tide may lift all ships, but valuation differentiation, based on fundamentals, is missing. In an article discussing the recent performance of active managers, the Wall Street Journal cited a study which divided stocks into four quadrants: inexpensive low growth stocks, expensive high growth stocks, inexpensive high growth stocks, and expensive low growth stocks. **For the first half of this year, expensive low growth stocks were the best performers, while inexpensive high growth stocks, the stocks which we target for your portfolio, were the worst performers.** Perhaps this upside down return scenario can be explained by another recent phenomenon.

Simultaneous to the post-Great Recession shift to quantitative easing, with increased financial regulation, another force has disrupted the market pricing mechanism. Over the past few years, large pension cash flows, from both domestic and international sources, have moved from active to passive equity strategies. Because of their size, these mega-investors believe they have little alternative than to own the entire market. **Since these index strategies are capitalization weighted, and with market trading liquidity impaired by regulation, their purchasing activity has distorted the prices of the very largest capitalization stocks and those stocks whose average trading volume is far less than their market capitalization would imply, e.g.**

staples, telecommunications, utilities and higher yielding bond substitute stocks.

When funds first flowed into passive strategies in the 1970s, Grossman and Stiglitz wrote a paper on market efficiency. They concluded that as more money flows into passive strategies, it creates opportunities for investors to seek, and find, inefficiently priced opportunities. What they describe is a cyclical pattern of under/out performance. Callan Associates, an institutional investment consulting firm, claims that there has been four complete cycles, since 1991, where active portfolio management has outperformed passive strategies, and vice versa.

From their data, it would appear that we have reached an inflection point where individual stock valuations represent a compelling opportunity. We saw glimpses of such opportunity last year in small caps, where portfolios of individual stocks significantly outperformed their benchmarks. We saw evidence again, during the past quarter, in the differentiated reaction to second quarter earnings reports. In this most recent quarterly reporting cycle, individual stocks reacted disproportionately to the news they reported, initiating a rotation into sectors which had languished for the past year.

With the market still characterized by high individual stock correlations and low dispersion, it continues to be vulnerable to headline risk, in spite of a lack of any significant economic impact. While any number of events could be used as an example, perhaps Brexit had the greatest short-term market impact compared to its negligible economic impact. Indeed, Brexit serves as a model as we contemplate our strategy for the Presidential election in the United States. Since voters are polarized and both candidates are unpopular, enormous claims are being made regarding post-election policies. The problem is that the election is still too close to call. Besides, the composition of Congress is still undecided and, given their lack of popularity, we can expect significant pushback to either candidate's agenda, regardless of which party controls Congress. It seems, at this point, the only common ground is that both candidates seem to agree that the country needs more government spending, but this too may be moot, since the next President will inherit a record government debt.

In spite of the outcome of the election, stock market returns will reflect economic success. Perhaps our greatest optimism for continued economic growth and positive stock market returns is the evidence of what appears to be the beginning of coordinated global improvement.

Fixed Income

Perhaps the most watched, and least functionally important, interest rate is the federal funds rate. The fed funds rate is the interest rate at which banks lend reserve balances to other banks overnight on an uncollateralized basis. Reserve balances are the money held by banks at the Federal Reserve to meet reserve requirements. There are two fed funds rates, the effective rate, which is the weighted average of all such negotiated loans between banks, and the targeted rate, which is determined by a meeting of the members of the Federal Open Market Committee. The Federal Reserve uses open market operations to influence the supply of money in the U.S. economy to make the effective rate follow the target rate. **The target fed funds rate is an important benchmark in the financial markets, which explains the significant speculation and concern over the Federal Reserve Bank's stated goal of normalization, the process of raising the target rate to a neutral or equilibrium level.**

The Federal Reserve uses the fed funds rate as a tool to guide U.S. economic growth. In the course of using open market operations to influence the money supply, the Federal Reserve can provide liquidity to the economy or tighten the money supply. Providing liquidity stimulates economic activity while tightening the money supply slows economic activity. That, however, assumes the target rate is at equilibrium, which it isn't. The current fed funds rate is targeted between .25% and .5%, effective December 16, 2015, but the Federal Reserve Bank thinks a neutral rate should be about 3%. **This means that any rate below a neutral rate will provide liquidity to, and stimulate, the economy.**

After the Fed raised the fed funds rate last December, two things happened: short term interest rates went up and longer term interest rates came down. The yield curve flattened. The benchmark 10-year U.S. Treasury bond went from 2.27% at year end, to 1.49% on June 30. That is a huge move. When the Fed raised the fed funds rate, the market perceived the Fed was acting preemptively to contain inflation. **Since U.S. interest rates were already the highest in the developed world, and it appeared the dollar would remain strong, more money continued to flow into longer maturity Treasury bonds, forcing yields lower.**

At year end, the Fed proclaimed normalization of the fed funds rate would be accomplished by four increases over the course of 2016 and more into 2017, until it achieved a neutral rate. **Now, it is widely believed we may see one rate increase in 2016, and that isn't certain.**

It was once thought the Fed's mission was to manage the money supply in order to prevent inflation. **In recent years, the Fed took on the responsibility of managing the economy to attain full employment. Now the Fed seems to have assumed the responsibility of coordinating with other central banks to manage exchange rates, in order to stimulate the global economy.** Since these goals aren't necessarily compatible, it will be interesting to see how the Fed balances its priorities.

International Market

During the most recent quarter, a number of factors have impacted the global markets. Investors, in general, have focused on three main factors: the price of crude oil, the U.S. dollar and the Brexit vote. Each of these factors has caused volatility in the market and fear among some market participants. **However, based on our fundamental review of each factor, we believe the market's reaction to the price of crude oil and to Brexit is merely a psychological reaction to uncertainty, and expected to be short-lived. Therefore, we advise caution for investors who are "reactive" to news headlines, as they are at risk of being whipsawed.**

Crude oil prices have experienced a freefall and many investors mistakenly feared that the decline was due to a lack of demand, signaling a weakening global economy, rather than the oversupply which resulted from new extraction technologies. This fear has not materialized as the global demand for crude continues to grow at a normal 1% to 1.5% annual rate. A more valid concern may be that the lower price of crude oil has led to a

reduction in energy companies' capital expenditures. However, the negative impact from lower capital spending is more than offset by the economic gains from lower energy prices, which are still to be fully realized. **Lower crude prices essentially serve as a windfall tax cut which increases the average consumer's disposable income and should therefore be viewed as a stimulus, rather than a headwind, to the global economy.**

The impact of a strengthening U.S. dollar on the global market is multi-dimensional. On one hand, a sharp upward surge in the dollar exchange rate can trigger a reversal of "hot money" flows from emerging markets back to the U.S. These relatively large capital outflows can produce significant volatility for local assets within emerging markets; they can even force a vulnerable emerging market economy into recession. On the other hand, the resulting cheaper local currency tends to make product pricing from these markets more attractive. **Since many of the emerging market economies are export dependent, the higher demand would benefit the underlying local economies and should therefore be viewed as a long-term positive for the global market, at the expense of U.S. export industries.**

It is important to revisit the Brexit vote, while it is still fresh on investors' minds. The impact of this headline event was mostly psychological, even though many investors mistakenly viewed it as having a real economic impact. As described earlier, "Brexit had the greatest short-term market impact compared to its negligible economic impact," yet the damage to those investors who did react was very real, as they were left behind watching the market quickly rebound to new highs. The lesson to be learned is that when an event breaks, the worst thing an investor can do is panic and let emotions lead to irrational investment decisions. **News headlines should be critically examined to determine whether there is, indeed, an economic consequence and whether the impact is already reflected in the price of the asset.**

Even though we have concluded that Brexit was a political rather than economic event, with minimal near-term economic impact, it revealed the power of populism, which may have very real effects on globalization and the global economy. For the past two decades, globalization has enabled greater mobility of goods, services, capital and labor around the world. The rapid integration of trade and global supply chains has resulted in profit margins rising to record levels, benefitting the global economy. However, globalization also carries a perception that it has come at an untenable cost for local workers in high wage economies, causing a stagnation of middle-class incomes and frustration over social inequality. The current refugee crisis puts a human image on this inequality and social upheaval, which further fuels the spread of today's populist movement.

A scenario where the populist movement gains traction, or even becomes mainstream, could present a potential challenge to future economic growth. Anti-globalization pressures could erect barriers to trade, and one of the consequences may be higher labor costs. Although a tighter labor market could arguably boost real income among local workers and benefit middle-class households, it could also lower profit margins. As a result, the anticipated boost to labor compensation would occur at the expense of return on capital. **Whether the impact to an aggregate economy is a net positive or negative is subject to debate, but, on a global basis, efficiency would be reduced and tensions would rise.**

As evidenced by the recent round of G-20 talks held in China, global leaders apparently realize the seriousness of this issue and have started to address the potential consequences. **The worst case scenario, for the global economy, would be a collapse of the integration between economies, which has taken years to build, and for countries to become fortified under the shield of protectionism; in other words, a redux of the 1930s.** Sometimes it is good to recall George Santayana's quote: "Those who cannot remember the past are condemned to repeat it."