

Greece's Own "Lehman Moment"; Turning Slightly Bearish on Global Stocks

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Our 12-month Outlook for Major Asset Classes: Getting More Bearish on Global Equities

U.S. Treasuries	• Neutral; will remain well-bid given widening spread between U.S. Treasuries and German bunds, U.S. Treasury rates will remain low as long as Fed does not hike by more than 25 bps
Euro Zone Sovereign Bonds	• Neutral on German bunds; will remain well-bid in 2015 as ECB could purchase up to 80% of all German borrowing next two years, but yields will rise once economic growth accelerates
U.S. Equities	• Slightly bearish; Retail investors very complacent while U.S. equity valuations remain at their highest levels since early 2001; price momentum clearly decelerating
Developed Equities	• Neutral on Developed European and Japanese equities given overbought conditions due to recent rally; possibility of Greek default could shake up the Euro Zone's financial markets
Emerging Market Equities	• Slightly bearish given overbought conditions and as a lack of U.S. dollars in global financial system squeezes EM countries; but will become more bullish if China eases further
Global REITs	• Neutral on U.S. hotel REITs given decelerating momentum in U.S. stocks; Still relatively bullish on lodging REITs and select sectors such as outlet malls and cell phone towers
Precious Metals	• Neutral; bear market began 3 years ago and is close to ending as prices approach marginal cost of production; silver has more downside as it is mostly a by-product of copper, zinc, etc.
WTI Crude Oil	• Bullish, WTI at \$50 a barrel will kill new and high-cost shale production; U.S. oil demand will recovery strongly given lower gasoline prices and higher employment levels in 2015
Other Commodities	• Bullish on consumer metals, e.g. zinc but bearish on primarily construction metals, e.g. copper; bullish on uranium (CCJ) as Asian consumption rises; neutral on U.S. natural gas

Green = Revised from April 5, 2015 12-month Outlook (our 12-month general outlook did not change from that of last month)

Greek Default in the Spotlight for May-June 2015

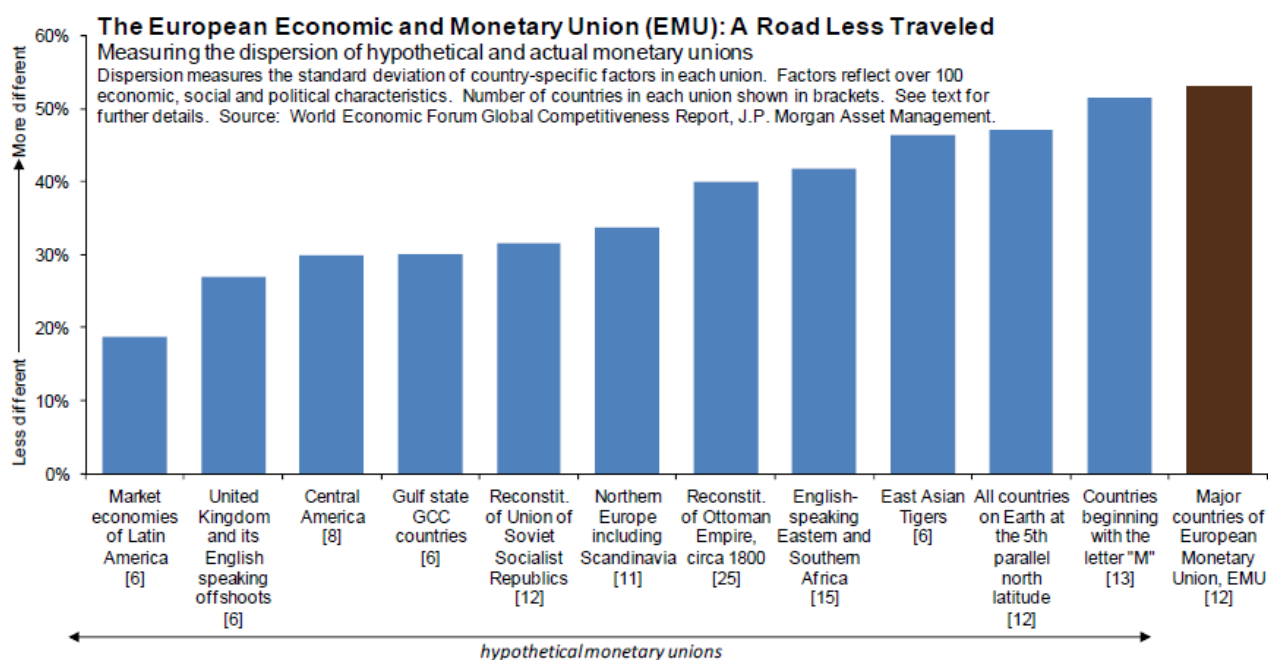
The chance of a Greek default or, at the least, a debt restructuring remains high. [Latest polls show that](#)—for the first time—the percentage of Greeks who are willing to default or exit from the Euro Zone has exceeded 30% (at precisely 37%). As we discussed in our [April 3, 2015 Forbes article](#): 1) currency or monetary unions between different economic regions with different cultures, demographics or income/wealth levels cannot be sustained, unless wealthier states subsidize their less wealthy counterparts through direct subsidies, with no strings attached, 2) different states within currencies unions do not generally have similar economies or similar economic cycles. This is especially apparent within the Euro Zone, where [Germany is currently running the largest trade surplus in the world](#) (a record high of 224.5 billion euros over the last 12 months, surpassing the size of China's trade surplus), while France is running a trade deficit. This means there must be a seamless way for labor to relocate from impoverished (e.g. Greece) to

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more prosperous areas where jobs are plentiful in order to smooth out economic growth across regions. The fact that the Euro Zone runs across vastly different cultures, languages, and heritage suggest the European Monetary Union (EMU) is doomed to failure unless Germany is willing to indefinitely subsidize its poorer counterparts, and 3) At 317% of GDP, Greece cannot meaningful reduce its debt load (which includes government and private debt) through austerity measures or a lower Euro. Rather, it must bring its debt levels down either through increased economic growth or a restructuring of the country's debt. Throughout history, the number of countries that have achieved such a dramatic reduction in debt is small—usually through a combination of hard work and sheer luck (e.g. Canada reducing its debt-to-GDP ratio from 91% in 1995 to 51% in 2007, driven by strong global economic growth and rising commodity exports and prices). Greece will not likely be able to reduce its debt levels unless it restructures its debt with its European creditors.

Figure 1 below comes from a [2012 study by JP Morgan](#) that quantifies the amount of dispersion among Euro Zone members. The study utilizes over 100 economic, social, and political characteristics taken from 142 countries via the World Economic Forum Global Competitiveness Report. According to JP Morgan, these include: “*factors related to labor and goods market efficiency; government institutions (property rights, corruption); macroeconomic soundness (debt, deficits); health and education; business sophistication (local supplier quality/quantity); and capacity for innovation (quality of scientific research institutions, R&D spend, patent grants).*” Interestingly, the EMU members have the most dispersion among various hypothetical monetary unions, including the market economies of Latin America, the UK and her English-speaking offshoots (Scotland now wants to go the other way and become an independent country), the GCC countries, and interestingly and randomly, all countries beginning with the letter “M.” Note all these countries have decided against forming any monetary unions; and history is littered with failed monetary unions.

Figure 1: The European Monetary Union Should Not Exist Based on Political, Economic, and Legal Factors



I believe a Greek restructuring sometime this summer is inevitable. Over the last 10 days, the 2-year Greek sovereign yield declined from a high of 30% to below 20%. I believe investors are too complacent as the macro narrative has not changed, i.e. both Greece and the Euro Zone's finance ministers (including Germany and the IMF) are still ideologically far apart in terms of coming to a compromise to unlock the next tranche of bailout funds. Moreover, the handling of the talks by Greece's leftist Syriza government has so far only alienated its creditors—as well as encourage more capital flight (the Bank of Greece just announced that [Greek bank deposits fell to a record low of 138.6 billion euros in March](#) from 140.5 billion euros the month before); the Syriza government has



also caused a humanitarian crisis, as retirees are now struggling to get their monthly pension checks, while businesses have virtually halted all investments, pending a resolution to the crisis.

My sense is that European policymakers have effectively backed themselves into a corner with regards to the financial markets. True, they may have other, political motivations, but as investors, we only care about asset prices. In my opinion, there is really no “best case scenario” for asset prices. A Greek default or exit from the Euro Zone will likely result in a financial market dislocation, as well as capital flight from the Euro Zone’s peripheral countries as investors begin anticipating a further fragmentation of the Euro Zone. If Germany chooses to take a haircut on its Greek holdings, other countries that have stuck to their austerity plans will begin to question the integrity of the EMU—at the very least, leftist politicians in countries such as Spain or Portugal will begin to demand similar haircuts as well. If Greece receives another extension (in this scenario, the ECB will provide more emergency funding for Greek banks to purchase the government’s short-term debt), this will just result in more uncertainty—with the Greek economy going further into a downward spiral as Greek citizens delay investments and spending.

Bottom line on Greece: There is no “good scenario” that could emerge from the Greek fiscal crisis. At the very least, a haircut taken by its European creditors will lead to more deflationary pressures in the Euro Zone, and possibly around the world. Last Friday, our Absolute Return Liquidity fund purchased more U.S. Treasuries as prices dipped as I believe Greece is approaching its own “Lehman moment.” We anticipate some “flight to quality” into U.S. Treasuries by global investors over the next 4-6 weeks.

Across-the-Board Downgrade to Our 12-month Outlook for Global Equities

Before I discuss our rationale for our across-the-board downgrade on global equities (U.S., Developed, and Emerging Markets), I want to make some quick comments about the recent decline in global sovereign bond prices:

- **Euro Zone Sovereign Bonds:** On April 20th, the German 10-year yield sunk to a record low of a mere 8 basis points; by last Friday, the German 10-year yield closed at a two-month high of 0.36% as both Bill Gross and [Jeff Gundlach](#) went on air describing German sovereign bonds as the “short of a lifetime.” As I previously discussed, I have been generally neutral on high-grade European sovereign yields (i.e. German, Finnish, Danish, and Dutch yields) because of the immense size of the ECB’s QE policy. Despite the prevalence of negative sovereign yields, the ECB’s purchase of sovereign bonds is projected to be 2.5x that of sovereign net issuance this year. The lack of sovereign bond supply is especially acute for Germany, Finland, and the Netherlands. As such, it is likely that German, Finnish, and Dutch yields will continue to remain low. That said—in the event of a Greek exit or Greek default—it is also likely that investors will be pricing in a potential fragmentation of the Euro Zone, resulting in higher yields in the peripheral countries such as Spain, Portugal, Ireland, and even Italy. Because of the many contradictions inherent in Euro Zone sovereign bonds, we will leave it as ‘neutral’ and will avoid the asset class for now.
- **U.S. Treasuries:** U.S. Treasury yields rose in sympathy with European sovereign yields late last week; the rise in U.S. Treasury yields last week was amplified by the lack of liquidity in the markets. I used this opportunity to build a bigger position in U.S. Treasuries in our Absolute Return Liquidity Fund last Friday, as: 1) The recent U.S. economic slowdown—especially in U.S. industrial production and manufacturing—suggests that the Fed will not hike rates until the December 15-16 FOMC meeting at the earliest, 2) the spread between the U.S. and German 10-year yield is still close to its 30-year high; this will continue to encourage global fund flows in favor of the U.S. over Europe. In addition, the threat of a looming Greek default will also serve to keep U.S. Treasury rates low for the foreseeable future. While most investors are foreseeing a rise in the U.S. 10-year Treasury rate to the 2.5%-3.0% range this year, this is by no means a “slam dunk.” Since the Fed began its zero-interest-rate policy six years ago, the vast majority of “Fed watchers” have been predicting an imminent rise across the U.S. Treasury yield curve. This has not yet materialized and while this could occur in 2015, I do not believe this will occur anytime soon given the slowdown in U.S. industrial production, the ECB’s ongoing QE policies, and the threat of a looming Greek debt fault.



The U.S. Stock Market's Technical Condition Worsens: Targeting a 12%-15% correction in U.S. equities

In last month's 12-month outlook (see our April 5, 2015 newsletter), I discussed that the "cult of equities" among U.S. institutional and retail investors is still alive and well, despite two major bear markets in the last 15 years—the latter of which nearly triggered the collapse of the global financial system. This has been fueled by the collective "brain-washing" by the vast majority of MBA & CFA curricula, government-mandated 'automatic enrollment' policies of 401(k) plans, and the unending faith in the world's central banks to inflate the prices of financial assets through various quantitative easing (QE) policies.

QE policies adopted by the Federal Reserve, the European Central Bank (ECB), the Bank of Japan, the Bank of England, and the Swiss National Bank have driven U.S. equity valuations to their highest levels since early 2001 (measured by NTM P/E and current P/B Ratios). I have been warning about an imminent correction in the U.S. stock market for the last couple of months, given: 1) historically high valuations, 2) the declining earnings picture for the S&P 500, even excluding the underperforming energy sector, and 3) the extreme complacency among both retail investors and hedge funds.

As I have highlighted since March, the technical condition of U.S. stocks has progressively gotten weaker. In our March 15, 2015 newsletter, I highlighted the weakening U.S. technical conditions through a study of the five largest U.S. companies by market cap, i.e. AAPL, GOOG, BRK-A, XOM, MSFT, i.e. the fact that all five companies had already peaked during the June to December 2014 timeframe, even as the major indices continued to rise. Both APPL and MSFT tried to rally through their 52-week highs last week (for APPL, its all-time high; MSFT recorded its all-time high back in December 1999), but were rejected. For APPL investors, this must be very discouraging given its better-than-expected earnings and numerous analyst upgrades in the aftermath of the earnings call. Just as important, former high-flyers such as Twitter (TWTR) and LinkedIn (LNKD) plunged by 25%-30% in the aftermath of their own earnings reports. The "rounding top" in the Dow Transports which has been forming over the last six months (the Dow Transports actually peaked in December 29, 2014) is also an ominous sign.

Sentiment: Our sentiment indicator, the **Combined Bulls-Bears% Differential Ratio**¹, ticked up last week even as global equity markets weakened. This is an ominous signal, suggesting too much complacency among retail investors (see Appendix A).

Bottom line: Due to a significant deceleration in both price and earnings momentum in global equities, declining US\$ liquidity (see our April 26, 2015 newsletter), historically high U.S. stock market valuations, weakening U.S. market internals, as well as extreme investors' complacency and the lack of a 10%+ correction in U.S. stocks over the last 3 ½ years, we are downgrading our 12-month outlook for the U.S. stock market from 'neutral' to 'slightly bearish.' We believe a market correction is now imminent; we do not believe this is the beginning of a major bear market, however, but we will strongly advise caution.

We are also downgrading U.S. REITs to 'neutral' as I do not believe that U.S. REIT prices will be immune to a general decline in U.S. equity prices. We are also downgrading Developed Equities and Emerging Market Equities given their short-term overbought conditions (see Figures 2 and 3 below), as well as a declining US\$ liquidity situation. We also believe the Chinese equity markets remain very frothy and could correct at any time (margin debt outstanding rose to a record high of \$294 billion, while new brokerage account openings surged to a record high of 4.13 million accounts last week).

U.S. stocks remain overbought based on the CB Capital Global Overbought-Oversold Model

The overbought conditions in the U.S. stock market are also being reflected in our CB Capital Global Overbought-Oversold Model, which we first discussed in our January 10, 2014 blog entry ("[The Message of the CB Capital Overbought-Oversold Model](#)").² **▲ quick introduction:** The model is designed to keep track of all country-specific MSCI market indices and country-specific equity

¹ See Appendix A for the latest reading and a description of the Combined Bulls-Bears% Differential Ratio.

² The inner workings of the CB Capital Global Overbought-Oversold Model are simplistic. For each country or region, we compute the month-end percentage deviation from its 3-, 6-, 12-, 24-, and 36-month moving averages. Each of these percentage deviations are then ranked (on a percentile basis) against all their monthly deviations (from their respective moving averages) dating back to December 1997 (May 2005 for the MSCI Frontier Market Index). This way, we can compare apples to apples as we can control for country- or region-specific volatility.



ETF products, including all developed and EM investable countries and regions. While we do not necessarily believe in shorting overvalued or overbought markets, we do, however, believe in going long distressed or oversold markets, as long as the long-term economics make sense. Our model was designed with this goal in mind.

The results for the major MSCI indices and Developed Markets as of April 30, 2015 are shown in Figure 2 below. All the percentile rankings highlighted in red or green represent rankings: 1) in or below the 10th percentile (i.e. oversold), and 2) in or above the 90th percentile (overbought), respectively. That is, relative to the historical percentage deviations of the same country or region, a ranking highlighted in red is more oversold than 90% of its readings going back to December 1997; while a ranking highlighted in green is more overbought than 90% of its readings.

As shown in Figure 2 below, the U.S. stock market (MSCI USA) remains highly bought on a three-year time frame. Its deviation from the 3-year moving average is currently at 88.9%, suggesting significant downside potential if the market corrects.

Figure 2: CB Capital Global Overbought-Oversold Model as of April 30, 2015

Index	Timeframe (months)				
	3	6	12	24	36
MSCI World	47.5%	53.3%	40.3%	42.3%	54.8%
MSCI EAFE	62.9%	68.7%	43.2%	44.7%	52.8%
MSCI EM	76.9%	68.7%	48.5%	51.9%	54.3%
MSCI AC World	51.4%	56.7%	40.8%	42.7%	53.3%
MSCI Frontier	52.1%	42.8%	23.5%	36.1%	51.2%
Developed Market Indices					
MSCI North America	42.3%	43.7%	41.3%	51.4%	70.1%
MSCI USA	32.4%	38.3%	50.8%	72.5%	88.9%
MSCI Canada	71.1%	51.4%	25.4%	34.6%	37.5%
MSCI Developed Europe	58.6%	64.4%	38.9%	40.3%	45.6%
MSCI Austria	83.1%	77.4%	43.2%	32.6%	41.8%
MSCI Belgium	39.4%	51.4%	52.4%	51.9%	59.1%
MSCI Denmark	86.0%	91.8%	65.8%	63.4%	70.1%
MSCI Finland	26.9%	30.7%	33.1%	39.4%	50.9%
MSCI France	61.0%	66.3%	38.9%	39.4%	47.5%
MSCI Germany	40.8%	54.3%	43.2%	40.8%	45.6%
MSCI Ireland	63.9%	74.0%	63.4%	62.0%	69.7%
MSCI Israel	69.7%	67.7%	61.0%	69.2%	73.5%
MSCI Italy	64.9%	71.1%	40.8%	43.7%	53.8%
MSCI Netherlands	56.2%	68.2%	59.1%	55.7%	67.7%
MSCI Norway	77.8%	72.5%	21.1%	21.1%	27.4%
MSCI Portugal	87.9%	87.9%	33.1%	20.6%	32.2%
MSCI Spain	60.5%	51.4%	31.7%	42.3%	52.4%
MSCI Sweden	35.0%	43.7%	35.5%	32.6%	35.5%
MSCI Switzerland	57.2%	60.5%	46.1%	46.6%	52.8%
MSCI United Kingdom	68.2%	64.4%	37.5%	38.9%	41.3%
MSCI Developed Pacific	70.1%	76.9%	65.3%	54.3%	62.0%
MSCI Developed Pacific x Japan	59.1%	57.6%	37.5%	40.8%	45.6%
MSCI Australia	37.9%	43.7%	20.6%	20.1%	18.7%
MSCI Hong Kong	89.4%	84.6%	76.9%	74.0%	74.0%
MSCI Japan	72.5%	81.7%	77.4%	66.8%	76.4%
MSCI Japan Small Cap	65.3%	69.2%	59.6%	61.0%	71.6%
MSCI New Zealand	36.5%	43.7%	34.6%	37.5%	44.7%
MSCI Singapore	76.4%	64.2%	48.1%	49.7%	48.6%



Emerging Market equities are short-term overbought based on the CB Capital Global Overbought-Oversold Model

What a difference a month makes. Driven by increasing Chinese liquidity and higher oil prices, EM equities powered higher by 7.5% in April. On March 31st, both the Brazil and Colombia stock market had become oversold (deviations below 10% of all historical readings) on four different time frames (6-month, 12-month, two-year, and three-year). At the time, I mentioned that I was not overly excited as both countries are still suffering from a long hangover after the end of the decade-long commodity bull market. For example, both countries are experiencing rising inflation as well as currency devaluations (Brazil's inflation rate sits at 8.1%; Colombia at 4.6%). Brazil in particular has squandered much of its commodity earnings over the last 15 years through a lack of infrastructure and educational investments. I also stated that I will not buy any Brazilian or Colombian stocks unless: 1) global liquidity begins to grow again, 2) Brazil & Colombia stocks become oversold on all five time frames, or 3) Chinese economic growth reaccelerates, accompanied by a closure of unprofitable Chinese iron ore or coal mines (not likely).

I maintain our relatively bearish views on both Brazilian and Colombian stocks, despite the 16.3% and 15.8% rally, respectively, in April. Interestingly, both the Brazilian and Colombian markets are now approaching overbought levels on a 3-month timeframe, which should put a cap on any short-term rallies. I believe EM equities are highly vulnerable given: 1) declining US\$ liquidity, 2) the overbought conditions in the MSCI China index, 3) what I believe is an imminent correction in U.S. equities, and 4) a potential Greek fiscal default over the next 4-6 weeks. As such, I have downgraded our 12-month outlook for EM equities from 'neutral' to 'slightly bearish.'

Figure 3: CB Capital Global Overbought-Oversold Model as of April 30, 2015

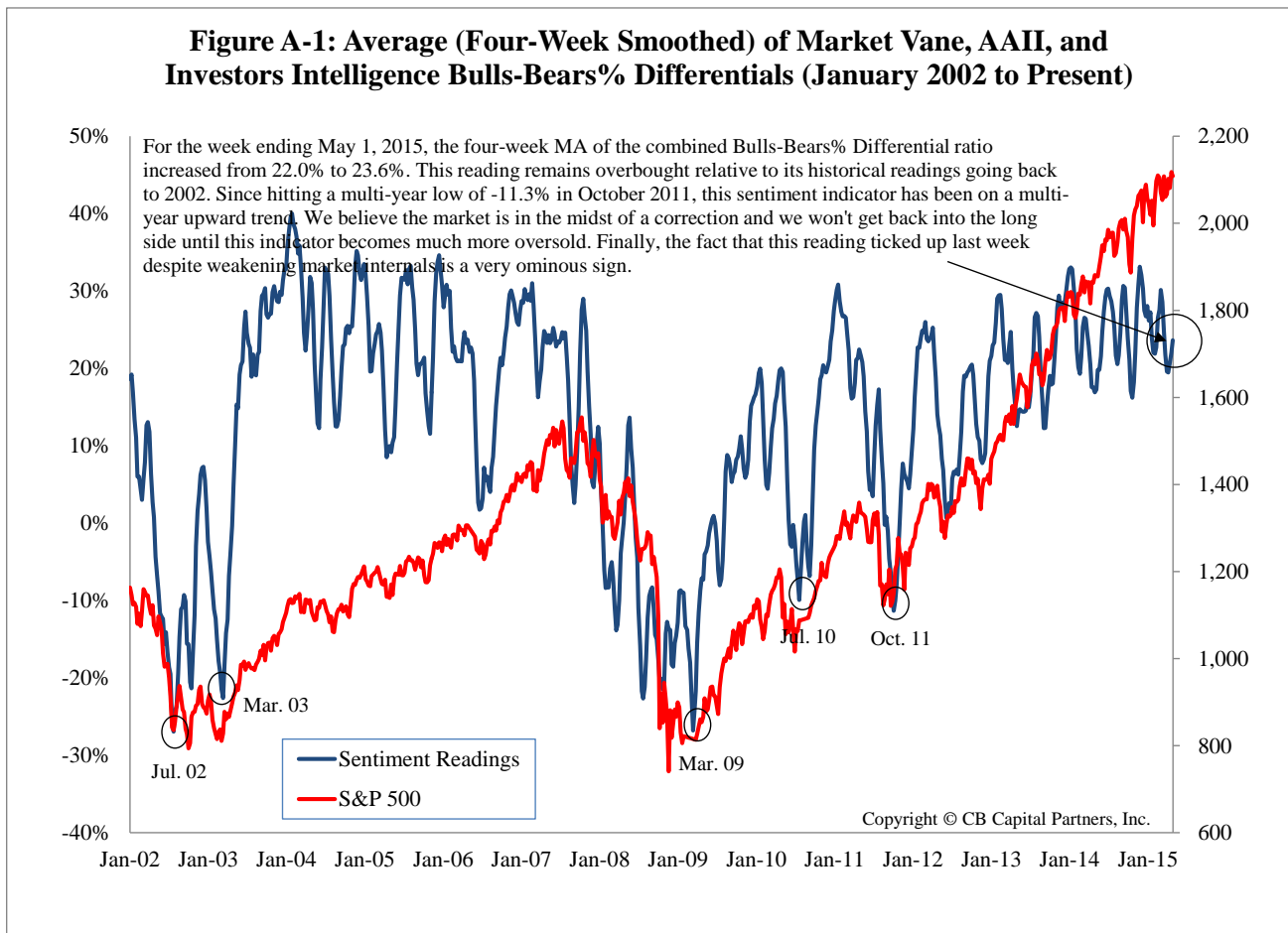
Emerging Market Indices	Timeframe (months)				
	3	6	12	24	36
MSCI EM Asia	75.9%	74.5%	61.0%	61.0%	65.3%
MSCI EM Far East	83.6%	78.3%	67.7%	62.5%	66.3%
MSCI China	95.6%	93.7%	89.4%	88.4%	83.1%
MSCI India	14.4%	25.0%	31.2%	50.0%	52.4%
MSCI Indonesia	13.9%	22.5%	23.5%	27.8%	34.1%
MSCI Korea	69.7%	67.7%	40.8%	32.2%	36.0%
MSCI Malaysia	59.1%	40.8%	21.6%	19.7%	23.0%
MSCI Philippines	32.2%	42.7%	46.6%	55.2%	56.2%
MSCI Taiwan	69.2%	71.1%	62.5%	74.5%	82.6%
MSCI Thailand	35.0%	36.0%	30.2%	32.6%	37.5%
MSCI EM Latin America	67.7%	43.7%	22.1%	21.1%	16.8%
MSCI Brazil	74.5%	46.1%	23.0%	26.9%	20.6%
MSCI Chile	63.9%	61.5%	46.6%	35.0%	25.4%
MSCI Colombia	79.3%	43.7%	14.4%	14.9%	14.9%
MSCI Mexico	34.1%	33.1%	17.3%	15.8%	14.9%
MSCI Peru	74.5%	57.2%	39.4%	51.9%	37.5%
MSCI EM Europe & Middle East	82.6%	62.9%	25.4%	20.6%	16.8%
MSCI EM Europe	81.7%	63.4%	27.8%	20.6%	20.1%
MSCI EM Eastern Europe	91.8%	61.5%	17.3%	14.4%	13.9%
MSCI Czech Republic	57.6%	44.7%	29.8%	37.9%	36.0%
MSCI Greece	47.1%	19.7%	9.6%	12.5%	31.2%
MSCI Hungary	99.0%	97.1%	78.8%	53.8%	46.1%
MSCI Poland	78.8%	62.5%	36.0%	36.5%	45.1%
MSCI Russia	86.0%	87.0%	36.0%	23.0%	22.1%
MSCI Turkey	37.5%	26.4%	26.4%	27.4%	23.5%
MSCI Egypt	34.1%	31.7%	40.3%	58.1%	60.0%
MSCI South Africa	59.6%	56.2%	51.4%	59.1%	59.1%



Appendix A

One of the most reliable measures of U.S. investor sentiment is our proprietary U.S. stock market sentiment indicator—the “**Combined Bulls-Bears% Differential Ratio.**”³ Calculated on a weekly basis, it is a contrarian indicator, i.e. highly bearish sentiment usually indicates a major stock market bottom, while highly bullish sentiment indicator suggests the lack of potential upside. Over the last 15 years, the Combined Bulls-Bears% Differential Ratio was instrumental in calling the stock market bottoms of July 2002, March 2003, March 2009, July 2010, and October 2011.

Figure A-1 below shows that—since the October 11, 2011 bottom—this sentiment indicator has been in a consistent upward trend and has not once dipped into negative territory (i.e. a reading where bearish outweighed bullish forecasters). The Combined Bulls-Bears% Differential Ratio dipped to 16.2% during the October 2014 sell-off, which is neutral territory at best. This means U.S. retail investors remain very complacent. Last week, this reading increased from 22.0% to 23.6%. The fact that this reading ticked up last week—despite weakening market internals—is a bearish sign, suggesting the U.S. market correction has more room to run.



³ The Combined Bulls-Bears% Differential Ratio is constructed by aggregating the three most reliable and time-tested sentiment indicators that track retail investors' sentiment on a real-time basis. These are: 1) the [Market Vane's Bullish Consensus Index](#), which tracks the buy and sell recommendations of leading market advisors, 2) the [American Association of Individual Investors \(AAII\) Sentiment Survey](#), which measures the percentage of individual investors who are bullish or bearish on the U.S. stock market for the next six months, and 3) the [Investors Intelligence U.S. Advisors' Sentiment Report](#). We then smooth the aggregate of these three using a four-week moving average, which we label as the “**Combined Bulls-Bears% Differential Ratio.**”



Biography

Henry To, CFA, CAIA, FRM

Partner, Chief Investment Officer

Mr. To currently serves as Partner and Chief Investment Officer for CB Capital Partners by leveraging his many years of investment, consulting, and valuation experience. Mr. To has extensive experience in institutional asset management, portfolio allocation, global macroeconomics, and international public policy. Mr. To brings his unique business ideas, entrepreneurial mindset, managerial experience, and professional consulting skills to CB Capital Partners.

Previously, Mr. To was the Founder and Managing Partner of MarketThoughts LLC, an investment advisory service catering to global investors, including the world's largest alternative asset management firms (e.g. Tudor Funds and Raptor Group). Prior to MarketThoughts LLC, Mr. To held Investment, Energy Consulting, and Actuarial Consulting positions with firms such as Buck Consultants, Lukens Energy Group (now part of Black & Veatch), and Mercer, where he obtained substantial experience in institutional asset management, project management, and performed valuations on non-traditional assets such as ERISA pension/actuarial contracts, natural gas storage fields, and weather derivative contracts.

Mr. To is also an Adjunct Professor at the UCLA Luskin School of Public Affairs. In that capacity, Mr. To created a class curriculum and lectured on a variety of public policy areas, including international monetary policy, national security, education, and crime policy. In addition, Mr. To has been an instructor in the USC/CFALA Review Program, where he taught the CFA Exam Level II Economics section. Mr. To is a regular contributor on the Forbes 'Great Speculations' blog and has been interviewed and quoted by the New York Times Business Section, the Wall Street Journal, MarketWatch, TraderPlanet, among other publications. Mr. To has also been a featured speaker at the Western Pension & Benefits Conference (Orange County Chapter), where he discussed the role of private equity and infrastructure investing in pension fund portfolios.

Mr. To received a BA in Mathematics and Economics from Rice University, an MBA in Finance from UCLA Anderson School of Management, and a Masters of Public Policy (MPP) in International Policy from UCLA Luskin School of Public Affairs.



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