Pinnacle Capital Management, LLC

April 2017

PCM UPDATE

Equity Strategy

We will keep the overview portion of the Equity Strategy section brief, as much was covered in PCM's corresponding Commentary piece. The S&P 500 returned 6.07% in the quarter, driven by consumer discretionary stocks and technology. We cited a rise of "story" stocks, optimism with regard to the Trump agenda, and strong consumer sentiment. We also sighted as cautionary areas political uncertainty in Europe, a widening spread of valuation levels in U.S. equity markets, and uncertainty as to whether the Trump agenda can be adopted or successful if adopted.

While returns for our clients were generally positive, the performance of those portfolios clearly lagged the broad markets. On a broad basis, underperformance was driven by lower exposure to tech stocks, lack of exposure to housing and home improvement stocks, and over exposure to telecom stocks. This was partially offset by strong performance by our chemical stocks and a low portfolio weighting in the energy sector.

On a positive note, Apple Inc. (AAPL) had stellar performance, returning in excess of 24% for the quarter. Unilever (UL) also gained in excess of 20% as Kraft Heinz (KHC) offered to purchase the company. Although this bid was rejected, and KHC declined to pursue UL further, the company has recommitted to increasing shareholder value and has already taken positive steps. This move is indicative of a transformation occurring in the food industry. It is becoming increasingly difficult to launch new products and distribute them on a global basis. As a result, the value of existing brands and distribution systems are increasing. Merger activity has been heating up. One company held by clients, Mondelez (MDLZ), proposed an acquisition, since withdrawn, of Hershey (HSY) in late 2016. MDLZ itself generated a return of -2.4% in the quarter.

Our auto and related holdings were a mixed bag in the quarter. Fiat Chrysler (FCAU), our strongest performer in last year's 4th quarter gained just under 20% for the 1st quarter of 2017. Meanwhile Tenneco (TEN) was essentially flat despite generating surprisingly strong gains in sales and earnings; and Ford (F) returned -2.49%. We think the valuations of these three stocks are absurdly low, with price / earnings (P/E) ratios in the single digits. This reflects the markets apparent perception that earnings for these companies will collapse soon. We think the markets are mistaken on this one.

As mentioned previously, chemical companies performed nicely with Dow Chemical (DOW) and Eastman Chemical (EMN) returning 11.8% and 8.1%, respectively, for the quarter. DOW and DuPont Chemical (DDD) are in the process of merging. The subsequent combined company intends to then break into three new companies centered about business focus. Regulatory approval is expected soon. We think the market still doesn't appreciate the efficiencies that will be realized.

Our industrial holdings were mixed in terms of relative performance. Barnes Group (B) and ITT (ITT) outperformed the market in the quarter, while

United Technologies (UTX), MSA Safety (MSA), and Xylem (XYL) generated positive, though market lagging, returns. General Electric (GE) had a small, single digit percentage negative return.

In health care, Mylan NV (MYL) had a slightly positive return, while Teva Pharmaceutical (TEVA) returned -10.62% for the quarter. Both these stocks have single digit P/Es, and we're quite frustrated (as you must be) with performance. Both exhibit headline risk where underlying fundamentals are ignored. In the case of MYL, the stock has been impacted by well publicized headlines regarding pricing of its EpiPen product. In the face of this, sales and earnings have been quite strong, but the market seems not to care. In the case of TEVA, the specific headlines center about the loss of patent protection on one product. This has been well known for years and we think is over discounted by markets. In both cases, headlines and presidential tweets with respect to the industry have hurt the stocks. When will the markets focus on strong underlying fundamentals? We don't know.

Finally for this section, we will discuss BRF SA (BRFS). BRFS is a Brazilian food processor with revenues distributed roughly evenly between domestic and export markets. Several years ago we sold our other Brazilian holding, Pao De Acucar (CBD). CBD is a Brazilian retailer strictly in the domestic market. A weak economy and falling currency valuation led to that sale. We held onto BRFS because we thought the company would hold up much better in such an environment due to its export business. We thought the weakness in BRFS's stock price was overdone. However, accusations have arisen that BRFS may have falsified food safety test results. We don't know what the truth is but we recognized that BRFS' exports were now imperiled. As a result we sold the stock late in the quarter.

Looking forward, we're in a bit of a quandary. We see many exceptional companies that we'd like to own but whose stock prices seem too expensive. We're finding it harder to find inexpensive securities in areas in which we're not already invested. We'll continue to dig for such situations, but will be cautious. If high fliers continue to fly, we could miss out. However, it has always been our position that we'll not chase returns. Safety is more important.

Fixed Income Strategy

It was interesting quarter for fixed income. The Federal Reserve increased its benchmark Fed Funds rate for the second time in as many quarters. However, the interest rate on the 10 year Treasury bond, which rose from 1.59% to 2.44% in last year's fourth quarter, ended 2017's first quarter at 2.39%. The slight decline in interest rates, along with interest payments, resulted in the Bloomberg Barclays Aggregate Bond Index (BBAB) returning 0.82% for the quarter. Intra-quarter, the 10 year rate peaked at 2.63% in mid March and has now fallen to about 2.25% as we write this in April. What makes this even more interesting is that this happening as we're seeing some initial signs of inflation and as energy prices seem to be increasing again.

We stated last quarter that we couldn't be sure if the recent rise in interest rates was the end of the bull market in bonds. We also stated that we wouldn't be surprised if interest rates backed down slightly, especially if the markets enthusiasm for accelerated economic growth were overdone. We've obviously seen rates back off. Yet the equity markets have retained their belief in economic growth. Clearly a difference of opinion exists between the stock and bond markets. We suspect that global uncertainty has added to the strength in bond prices (and weakness in bond yields). Additionally, the current Administration's anti-trade rhetoric could be a factor. Still, we'll maintain our posture of taking on slightly more credit risk - i.e., the risk that companies will pay off their interest and principal - while taking on less duration (or long maturity) exposure.