Pinnacle Capital Management, LLC

January 2013

ECONOMIC UPDATE

Failure to take action has as many consequences as taking action.

A New Year, Much Like the Old Year

"Insanity is doing the same thing over and over again but expecting different results."
Albert Einstein
"It's like déjà vu all over again."
Yogi Berra
"We have met the enemy and he is us."
Pogo

As 2012 wound down, we prognosticated upon what lay ahead. We reflected upon not just the last year, but the past dozen or so years as well. We, and America, have watched as monetary mismanagement led to the dot com crash of 2000. We watched further as monetary, fiscal, and policy missteps in subsequent years helped bring on the housing crash of 2007. This crash led to a near global financial meltdown in 2008 as markets seized up and governments worldwide stepped in attempting to avert catastrophe. Since then economic growth has been anemic, public debt burdens have exploded, unemployment levels remain near historical highs, and, according to the polls, confidence in Washington is near an all time low. Under such a scenario, one might have expected the American people to rise up and say, "Enough!"

(continued)

Economic Statistics

	4th Qtr (12/31/12)	3rd Qtr (9/30/12)	*% Change*	1 Yr Ago (12/31/11)	*% Change*
S&P 500 Index	1,426.19	1,440.67	*-1.0%*	1,257.6	*13.4%*
10 Year Treasury Yield	1.76%	1.63%		1.88%	
Gold Spot ($ / oz)	$1,675.35	$1,772.10	*-5.5%*	$1,563.70	*7.1%*
WTI Crude Oil (next future)	$91.82	$92.19	*-0.4%*	$98.83	*-7.1%*
GDP Qtr / Qtr	N/A	3.1%		4.1%	
CPI Y / Y	1.8% (Nov)	2.0%		3.0%	
Unemployment Rate	7.8%	7.8%		8.5%	

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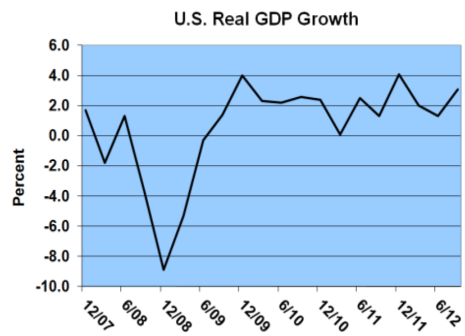
At the critical juncture of the November elections, perhaps the American people would have put their faith in President Obama and reelected him, simultaneously providing him support with a Congress led by Democrats amenable to his policies. Or perhaps the American people, frustrated with the progress of the past four years, and having thrown out the Democrat majority in the House of Representatives two years ago, might have followed through by throwing out both the incumbent President and the Democratic majority in the Senate. Clearly the American people were unhappy and wanted change. Yet America opted to avoid change by electing the exact same President and virtually the exact same Congress that brought us to the edge of the fiscal cliff.

And what, so far, has been accomplished? As we write this Update, Washington has arrived at a deal which will keep this country from falling off the precipice of the fiscal cliff. As a result of this deal, payroll taxes for all workers will rise by two percentage points. Those earning over $400,000 will see both their marginal tax rates and taxes on investment income increase. Also, the estate tax rate increases on estates in excess of $5,000,000. Significantly, no action has been taken on the expenditure side other than an agreement that in the future Congress will meet to take some action. The bill estimates that all provisions will reduce the deficit, on average, by $62 billion per year over ten years; assuming, of course, that nobody changes their behavior to avoid taxes. Such brinkmanship for this? We can only shake our heads and reflect that these outcomes are not a result of some leadership imposed on us, but of decisions that we have repeatedly made in the privacy of our voting booths.

> At any point, the world's creditors may reduce their desire for U.S. debt.

What happens next? First, the battles are not over. As of January 1, 2013, automatic Federal government spending cuts were supposed to take place. The current "grand compromise" only kicked this can down the road a few months. Also, another deficit ceiling vote is upcoming. We expect this battle to become particularly nasty. Meanwhile, uncertainty continues to prevail, and no great solutions seem to be possible out of Washington.

As in investing – in fact as in life – there is no such thing as not making a decision. Failure to take action has as many consequences as taking action. It is irrelevant whether this is intentional such as a decision to wait before investing in a security or unintentional due to decision paralysis when one doesn't know which course to take. Likewise, the lack of credible action in Washington will continue to have ramifications. One consequence is that individuals and businesses will likely remain somewhat risk adverse despite favorable risk / reward opportunities. This will continue to tamp down economic growth, which in turn will make it more difficult to solve our problems. The annualized rate of real GDP growth has been a dismal 2.2% since the economic trough of 2009 and 2.1% for the first nine months of 2012. Meanwhile, the Price / Earnings (P/E) ratio of the S&P 500 remains below 15 despite near record low interest rates. We have no doubt that the high degree of policy uncertainty is one significant, though not sole, cause of both substandard economic performance and reduced valuations on risk bearing assets. To further illustrate the impact of uncertainty, witness the brief euphoria that erupted on Wall Street when the fiscal cliff deal was concluded; this despite the lack of substantive progress on any meaningful reforms.

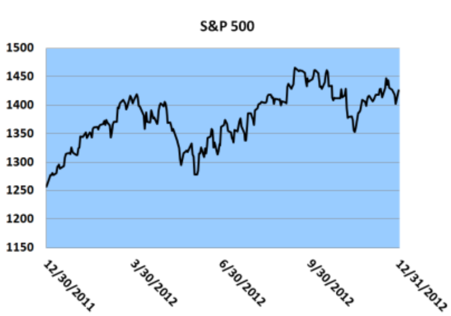


A second consequence is that instead of solutions being driven from within, solutions will be imposed from without. By this we do not mean to imply that some country, such as China, or some entity, such as the International Monetary Fund, will present the U.S. government with required reforms – though at some point this may be a possibility. What we are saying is that decisions outside of government and outside the U.S. will narrow down the available options and eventually force decisions that may or may not be palatable to the American people. So far we have been blessed (or perhaps cursed) with low interest rates. We are also able to borrow in our own currency. The U.S. is a debtor nation with slow economic growth running large deficits. Historically, such nations have to borrow in foreign currencies and at very high interest rates. At any point, the world's creditors may reduce their desire for U.S. debt and / or the U.S. dollar. At that point our ability to borrow to fund current consumption will come to an end.

Up to this point, this Update has taken on a particularly gloomy tone. But outcomes do not necessarily need to be negative. Decisions can be imposed from without not only from the standpoint that we've run out of good options, but also from a need to compete globally with more nimble nations. For example, lower corporate tax rates abroad may force the U.S. to lower its corporate tax rates to ensure domestic competitiveness. This in turn may force us to set other priorities. Or, a spurt of productivity gains in other countries – say Chile or Israel – may force us to emulate certain of their domestic policies. Looking from an historical perspective, more global freedom and economic growth has been created by the competitive forces of free and economically successful people (the two go hand in hand) than any other forces since the dawn of civilization. In fact these forces have been even stronger than the forces of despotism and global conquest. It is our recognition of these forces, our ability to search globally for investment opportunities, and the current state of reduced asset prices on risk bearing assets caused by a general state of pessimism that drive our current investment optimism.

Equity Strategy

Amid all the uncertainty and all the panic in 2012, stock prices had several major up and down swings. Ultimately the S&P 500 returned 16.0% inclusive of dividends. Given the wide swings, and the varying returns of our individual holdings, it is hard to discern many broad based themes from underlying results. Suffice it to say that overall, returns were positive but those returns did not exceed our equity benchmarks. While we strive to generate positive returns on a consistent and prudent basis, we are certainly not satisfied with results.



The year began on a very positive note as the equity markets, and our clients' stocks in particular generated strong first quarter returns. Early on we sold client holdings of Siemens (SI) as we felt that the slowdown in European economies would more than offset strong export markets. Depending on client funds availability, we purchased either or both of First Cash Financial Services (FCFS), an operator of pawn shops in the U.S. and Mexico, and World Fuel Services (INT), a global provider of logistics services to large purchasers of fuel.

After strong first quarter earnings, market sentiment began to focus on a deceleration of growth in the emerging nations. This shift in sentiment fed on itself, as the airways were saturated with stories regarding European economic weakness, the upcoming election, uncertainty about the President's health care law, and the looming fiscal cliff. Despite the strong first quarter earnings and anticipated strong second quarter earnings, markets fell as fears of slowing Chinese and other developing nation economic growth overshadowed underlying fundamentals. Our clients' holdings, which have a bias towards U.S. exports and developing nation consumption, were particularly hard hit. Between the market's early high on April 1 and the market low on June 1, we experienced 20%+ reversals in Apache Corp. (APA), Brasil Foods (BRFS), Caterpillar (CAT), EMC Corp. (EMC), and Grupo Pao de Acucar (CBD). Another stock, CACI International (CACI), fell over 30% due to a disappointing earnings outlook. We believed the price had fallen too far and we increased positions. By year end the stock had rallied in excess of 20%.

Following the second quarter decline, stocks steadily increased through the end of third quarter as fears began to subside almost as quickly as they came in to play. During this quarter, client stocks which depend on developing nation demand quickly rebounded. Among these stocks, several experienced double digit gains including BRFS and CBD, which experienced the large declines earlier, as well as FCFS and SAB Miller (SBMRY). Still not faring as well were industrial holdings, including Timken (TKR) and Caterpillar (CAT). While frustrated that the markets were not distinguishing between slowing growth and declining growth, we recognized that CAT sells large ticket items whose sales are subject to wider swings than those companies who sell small ticket items. As a result we sold CAT and bought DirecTV (DTV). What attracted us to this stock is not so much their U.S. operations (though this is a fine business), but the strength of their business from Mexico and south throughout Latin America. End markets there are growing

> A spurt of productivity gains in other countries may force us to emulate certain of their policies.

at double digit growth rates, and profits for DTV there are growing faster than demand.

Returning our focus to the broad markets, equities began the fourth quarter on a sour note, as nervousness regarding the upcoming elections and the looming fiscal cliff led to another market reversal. This reversal reached a crescendo in the immediate aftermath of the election. One week past the election all was forgotten – until the fiscal cliff reared its ugly head again. The markets gained roughly 7% between the November 15 intermediate low and December 18, and by December 28 gave up roughly half those gains. Ultimately, the markets were down slightly in the fourth quarter, though our clients' portfolios did make up some lost ground from earlier in the year.

It was a strange year with strange results, but the swings did reiterate our conviction that one should not get too caught up in short term market movements. Among our winners for the year were Walt Disney (DIS), TKR (despite a third quarter falloff), SBMRY, Mylan Inc. (MYL), Embotelladora Andina (AKO/B), and Aflac (AFL). Our most disappointing returns came from APA, Intel (INTC), TEVA Pharmaceutical (TEVA), International Business Machines (IBM), Microsoft (MSFT), and Xerox (XRX). In this latter list of stocks are a number of technology holdings. One of our investment themes as we entered 2012 was that corporate spending on information technology would be robust. Corporations actually held back on this spending during the year, though we do expect a reacceleration going forward. We also think valuations are absurdly low. In some cases they are at the point where companies borrowing even at junk bond rates could buy back their entire outstanding stock. When a company's valuation reaches this kind of level, it always attracts our attention – especially if the business prospects are sound going forward.

Turning to 2013, our view is not significantly different than it was as we began 2012. We anticipate earnings will continue to be strong among the developed nation industrial, developing nation consumer, and global technology sectors. It continues to be our opinion that both the U.S. and Europe will have to increase their focus on production and reduce their focus on consumption. In connection with this thesis, we believe that emerging market nations will undergo a shift as they reduce their emphasis on exporting goods to the developed world, replacing it with a greater focus on providing more for their own demand growth. Client investments will continue to reflect this outlook. As for the markets in general, we imagine that there will be many swings as battles over spending cuts, taxes, and debt ceilings continue. Still, valuations remain exceptionally low. While we always refrain from making specific predictions, we do believe over the next several years, investors should maintain equity positions towards the upper end of their investment tolerances. The price for this may be interim volatility, but the ultimate outcome, in our opinion, will be rewarding for those with patience.

Fixed Income Strategy

What can we say about fixed income that we haven't already said? Despite low yields at the beginning of the year, interest rates dropped further in 2012. After finishing 2011 at just under 1.9%, the 10 year U.S. Treasury yield fell below 1.4% in late July. Since then, yields have recovered, and the 10 year Treasury has generally fluctuated between 1.6% and 1.85%. The Barclay's Aggregate Bond Index, which is a broad measure of bond returns including interest and price movements, appreciated by 4.2% in 2012. Still most of those gains occurred by the time the 10 year Treasury yield bottomed in July. Between that time and year end, the index appreciated by 0.3%. Still positive, but not the gains investors have become used to.

Though it would be easier for us to throw in the towel on our conservative stance, there is no way we can look at the fixed income investing environment and want to make a major commitment to bonds. To the extent our clients have fixed income requirements, we have kept maturities short and have committed to some variable rate instruments. In doing so, we knowingly have given up some income found in bonds with longer maturities as well as return potential if interest rates fall. In fact, this position has been a detriment to our clients' fixed income returns. The flip side of this is that if interest rates rise, we avoid some of the downside. And, investors would likely have more funds to invest at higher rates should they occur.

As we said earlier, the U.S. is a debtor nation with large current deficits and a low rate of economic growth. It is only fear that is keeping demand for U.S. debt securities at its current levels. Corporate and other interest rates are strongly impacted by government rates, and as such, they are generally lower than we believe they should be. We're always evaluating upside and downside potentials along with the probabilities of each. It is because of this analysis that, with respect to the fixed income side of our investments, we have focused more on avoiding the downside than capturing the upside. Our holdings reflect this outlook. We recognize that fixed income needs to be a part of many investors' portfolio. The danger is that many such investors might fail to assess risk as they chase returns to get desired income. While we can never guarantee outcomes, it is our intention to be keenly focused on risk. Risk is acceptable to take on if the potential compensation for that risk is appropriate. But when the rewards are not apparent, one should hold off on taking that risk even if it means holding off on potential income for the present. It is frustrating not achieving the highest returns, but accepting the risk of higher losses could end up being even more so.