Pinnacle Capital Management, LLC

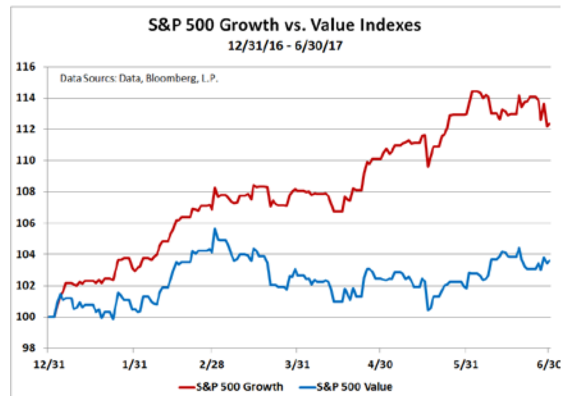
July, 2017

COMMENTARY

- PCM's investment philosophy centers about assessing risks and underlying potential returns, and taking that risk when appropriate.
- PCM implements this philosophy by evaluating individual stocks in terms of the underlying business value.
- PCM assesses that business value, building forecasts by evaluating companies' probability for success given ongoing economic, competitive, and demand environment.
- Utilizing that business value, PCM determines appropriate buy and sell points.
- While market prices tend to fluctuate about appropriate business value, especially over the long run, this strategy has the inherent risk that over shorter periods of times, markets will fail to focus on the fundamentals.
- We believe we are currently in one of those periods. Experience has taught us that more than ever, it is essential to focus on our disciplines.

Our typical Commentaries devote considerable space to economic and political developments impacting the stock and bond markets. In this issue, we're going to instead focus on the apparent divergence in how the markets view growth stocks and much of the rest of the market. Though the broad market indexes have had solid returns so far in 2017, those gains have not necessarily been distributed equally across the wide spectrum of stocks. As a result, keeping pace with the S&P 500 has been increasingly difficult for managers and investors alike. It's important to know why and question how you and your managers should be invested. Let's begin with the broad index returns. In the second quarter, the S&P 500 returned 3.09%, while for the year the return is 9.34%. Not too shabby!

Looking deeper, the S&P 500 can be divided into a large cap growth and large cap value index. Although the relative returns over long periods of time have been very similar, year to date that isn't the story. The nearby chart illustrates the divergence.



As you can see the difference in returns between the two indexes exceeds 8 percentage points. This represents a broad picture of growth versus value investing in 2017. If we dig further, we find that there are further divergences. Even among growth stocks, large capitalization growth stocks - tech companies in particular - have been driving the index returns. For example, the five largest stocks by market cap in the S&P 500 are tech stocks: Apple, Alphabet (Google), Microsoft, Amazon, and Facebook. Combined, they account for just under 13% of the S&P 500 weighting, but generated 31% of the return year to date.

That begs two questions. What's causing this divergence, and don't these results argue for loading portfolios with tech stocks? Lest we forget past lessons, let's recall the late 1990s. During that period if you weren't in tech stocks, your performance severely lagged the broad indexes. That is, until 2000. Unless you promptly sold in early 2000, it is likely that your portfolio returns were abysmal over the next three years. So is this a repeat of 1999? In general, we don't think so - except for the case of a number of high flying securities. In particular, as we mentioned above, many large cap technology companies are beginning to look significantly overvalued to us. The term "disruption" is now very much in vogue. If a firm is perceived to disrupt existing markets, any stock price seems to be justified.

We know we'll ruffle a few feathers as we give as an example a very popular holding of many individuals. Amazon.com, while growing rapidly, has retail operations that are barely profitable. (As a disclosure, we hold short positions in two funds we manage.) The so called scourge of all retail, Amazon's revenues and pretax margins are roughly 29% and 60% of Wal-Mart's, respectively. The comparison would be even less favorable to Amazon if we excluded their non-retail operations. Growth has been driven by cheap capital and low (or no) profitability. If Wal-Mart's investors didn't require a profit, there's no telling how the companies would be relatively positioned today (we hold no positions in Wal-Mart).

Looking at new ventures, Amazon has had virtually no success delivering food. Yet their purchase of Whole Foods, at an implied return of 3.5% on capital, has made markets tremble. Amazon has little experience running any brick and mortar store, let alone grocery stores. How are they going to increase returns? Operate more efficiently despite their lack of experience? Reduce prices? A 1% price reduction will require 29% more revenue just to offset the price cut. Will investors accept low returns from an Amazon owned Whole Foods despite punishing independently owned Whole Foods for its level of profitability? We don't know. Obviously investors currently see fit to justify a price earnings multiple for Amazon of over 180.

So there's no confusion, Amazon's situation is not unique. In our last Commentary we discussed Tesla (also a short position in funds we manage). We can also illustrate the case of Vertex Pharmaceuticals (no holdings). The stock returned 74.9% in the first half of 2017. Vertex does have some very promising drugs in the pipeline. Yet higher street estimates for revenues in 2020 are about $4.5 billion. Today, Vertex has market cap is $32 billion. That's a lot of faith in the future! In the cases of Amazon, Tesla, and Vertex, as well as others like it, we see a hint of 1999. We also can look forward and see hints of 2000.

While we know we're going against the current tide, we've seen this before. A new reality sets in. The old rules don't apply. Those who adhere to the old rules are a step behind. Managers and investors not adapting to the new reality are too stubborn or rigid. Younger generations and those with short memories may see less risk. Yet stocks are fundamentally interests in businesses. While many factors go into valuing a business, ultimately value is driven by profitability, cash flows, and dividends, all discounted to a present value. Over time, the market almost always punishes companies whose underlying returns are subpar. Of course, the operative words are "over time".

We've clearly, expressed our concerns, but does that mean it is time to reduce or eliminate our stock holdings in general? We don't think so. The other side of this divergence is that we've seen many stocks become excessively inexpensive in our opinion. We won't cover all of that here. The only real question is, is the economy in a position to continue expanding and support the growth and profitability of U.S. companies? We think so.

We've heard the arguments that growth is anemic, the expansion is long in tooth, and the Fed is raising interest rates. The first two issues go hand in hand. In fact low growth contributes to the ability to continue expanding. The flip side of a sluggish economy with a high level of fear is that there are few excesses. Without many excesses, the economy can continue to grow. What about the Fed raising interest rates? We think at this point it is not an issue. We're starting with exceedingly loose monetary conditions. That excessively loose policy has actually restricted, in our opinion, economic growth. We view recent Fed actions as a good thing.

Winding down, given significant stock market gains to date, "discipline" becomes the operative word. At times this might even mean foregoing some investment profits. While we're still cautiously optimistic about the stock market in general, we'll reiterate that in some cases the markets may have gotten ahead of themselves. Don't forget, however, that in other cases, the markets have yet to catch on. As always, we will be keeping our attention on the economy, business fundamentals, and valuations.

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