Pinnacle Capital Management, LLC

April 2013

PCM UPDATE

NOTE TO READERS:

As Pinnacle Capital has grown, we have increased our product offerings. Last quarter, we published our first **PAGGE Update**, which is more relevant to certain investors in our Pinnacle Aggressive Growth Global Extended Fund than is our **Economic Update** which we have long published. However, the first half of both publications encompassing our general commentary about the economy and markets were identical. Therefore, going forward, we will publish our **Commentary** as a separate piece as well as this **PCM Update** for the benefit of our separate account and mutual fund clients.

Equity Strategy

It is always easier to write about stocks when the markets, in general, have recently performed so well. For the 1st quarter of 2013, stocks advanced 10.0% (10.6% inclusive of dividends). It seemed like just yesterday that panic was setting in as we were heading towards the "fiscal cliff". Remember that? Since year end we have faced the "sequestration" and Cyprus crises. As we go to press, North Korea is misbehaving, and talk is beginning of the next debt ceiling crisis. They say that only two things are certain in life – death and taxes. To this perhaps we should add a third – there will be crises. The point to remember, though, is that crises pass. They don't always result in the outcomes one expects, but the near term impacts are often more wrenching than the longer term impacts.

Investing, if done properly, should be based on an assessment of the long term. Trading, on the other hand, is (in our opinion) a highly risky approach geared toward the short term. As such, we believe trading is much more subject to the near term impacts of various crises. Now, if one is very adept, it is possible to trade, taking advantage of crises to earn superior returns. Still, we would discourage most people from attempting this trading approach. That doesn't mean investors can't take advantage of crises. Often, if one's focus remains on the long term, one can take advantage of a crisis to position the portfolio for the long term. Unfortunately, the mistake investors tend to make is exactly the oppositie. They allow the most recent crisis to divert their attention from the long term, and instead take portfolio actions based on their gut reacton to the near term crisis. By the time the crisis passes, often the damage has been done.

Turning to client portfolios, several stocks generated strong returns in the quarter. Among our best performing companies were Xerox (XRX), Life Technologies (LIFE) and Hess Corp. (HES). We actually bought HES around year end, having sold Microsoft (MSFT) based on our review of their new product cycle – particularly Windows Phone and the Windows 8 operating system. Our thesis for MSFT had always been that the company would benefit from a strong corporate upgrade cycle. While we are impressed with Windows Phone, we do not think sales will be strong enough to move the needle. On the other hand, our impression of the Windows 8 operating environment is that while it may be fine for personal entertainment uses, it is a subpar product for use in business environments. Consequently, we significantly lowered our expectations for the current product cycle. On the other hand, we evaluated HES' portfolio of energy assets and came to the conclusion that it was highly undervalued. Fortunately for our clients, shortly after adding the stock to client portfolios, management announced it was exiting the refining business to concentrate on drilling and production. This caused the market to focus on underlying value, and we have to date seen nice gains.

LIFE had advanced for similar reasons. We initially bought LIFE and its predecessor company, Invitrogen, because of its position providing tools to the biotechnology industry. As an analogy, think of a company selling pick axes and shovels to gold miners. Recently, management has decided that to realize its inherent value it would put itself up for bid. The stock has advanced in recognition of this, and we expect the winner to emerge shortly.

We are greatly pleased to see XRX perform so well. XRX has been one of our (and we suspect our clients') great disappointments. XRX consists of two businesses – printing and business outsourcing. While printing is in slow decline, it is not going away. On the other hand, business ourtsourcing is a growing business. Combined, XRX is profitable and likely to grow in the low, single digits. While not a stellar company, we felt the value of the company fell to absurd levels. At its low, we believe one could borrow money at junk bond rates, buy back all the stock at a significant premium, and still have plenty of profits to pay back the debt. While we wouldn't put all our money into a company such as XRX, we would love to find more companies with such characteristcs. The stock appreciated by 26% in the 1st quarter, and we still think the stock is attractive at these levels.

Our disappointments were few this quarter. Those that stand out were Aflac (AFL), Apache Corp. (APA), EMC Corp. (EMC), and World Fuel Services (INT). To put things in perspective, these stocks were down between 1.3% and 5.5% - not disasters, but not what we had hoped for either. In all four cases, the market was dissapointed by the short term outlook. In light of the longer term prospects, we think all three remain attractive stocks at this point.

Fixed Income Strategy

We could have almost called this edition, "Fooled Again". Between December 6 of last year and March 11 of this year, the 10 year Treasury bond rate moved from 1.59% up to 2.06%. We were beginning to wonder whether this was the long awaited reversal in interest rates. Then Cyprus reared its ugly head (see PCM's currnet Outlook for more background). The next thing we knew was that the 10 year Treasury rate had fallen back down to 1.85% by quarter end. Rates on investment grade and below investment grade bonds with similar maturities also fell, but not as far. It seems that any time interest rates begin to back up, some domestic or global event puts the fear back into investors, who then proceed to rush headlong into U.S. Treasury bond investments. Consequently, broader interest rates which key off of Treasury bonds have remained lower than we believe is warranted given our overview of risk levels and potential for some modest inflation.

Not wanting to get caught in a rising interest rate environment which has the potential to generate negative returns for bond investors, we've maintained shorter duration than the broader markets. We've also taken on some credit risk. We do not believe, though, that this risk has been excessive. Our objective is to obtain some return, keep risk under control, and have funds in tact for the time when better opportunities are available. To that extent, we can claim some very modest success.

In many clients' accounts, we've utilized fixed income mutual funds, the most widely held being the Pioneer Strategic Income Fund (STIZX). With a return of just under 2% for the quarter inclusive of dividends, we are comfortable with the results. We've also generated positive returns with the Fidelity Floating Rate High Income Fund (FFRHX). This fund invests primarily in below investment grade floating rate notes and bonds. Average duration for its portfolio is under one year. Clients' positions in this fund give then exposure to potential positive returns when interest rates rise. In the meantime, current interest rates earned on the fund's underlying investments adequately compensate investors, in our opinion, for the risk taken on.

Overall, the options for the fixed income segment of client portfolios are not great. There is a balance between chasing potential returns and taking on too much risk. As we have stated for some time now, we want to err on the side of not taking on too much risk. That means we are more focused on preserving value than getting the highest return. While it may be frustrating for our clients, we sincerely hope the benefits of this approach will become more apparent as time progresses.