Pinnacle Capital Management, LLC

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PCM UPDATE

Equity Strategy

2013 will have to rank as one of our most satisfying years as equity investors. Sure, when returns in the stock market are approximately 30%, its easy to be satisfied. But it is much more than that. What has sat so well with us has been the stock market's steady progress despite a multi-year cacaphony of noise and distratctions. Prior to 2013, we witnessed three successive years of mid-summer swoons as the popular wisdom pronounced that another recession was just around the corner. Over the past year we've faced the fiscal cliff, debt ceilings, government shutdowns, and the threat of the Fed closing the monetary spigot. On the international front, hot spots seem almost always on the verge of overshadowing domestic issues. Wasn't the news from Syria, Iran, N. Korea, Egypt, or Russia bound to bring an end to the limited economic growth we've been experiencing?

And still, it wasn't just that the markets advanced in the face of negative press that we found so pleasing. What ultimately was so satisfactory to us was that the strong equity market returns were an indication that underlying fundamentals were finally winning the battle against emotion and speculation. For several years we've attempted to ignore the noise and focus on the fundamentals. Those underlying fundamentals convinced us that the equity markets had room to appreciate. We've made the case often in these Updates and implemented that posture in our clients' portfolios. In 2013 this posture was rewarded by the markets, and for that reason we're quite pleased.

The simplest way to review the year in equities is to begin with the indexes. The Dow Jones Industrial Average appreciated 26.5% for the year (29.7% inclusive of dividends) and the S&P 500 appreciated 29.6% (32.4% inclusive of dividends). While obviously some stocks and sectors performed better than others, the correct decision for 2013 was to have been invested in equities. Among the strongest gainers in our clients' portfolios were ITT Corp. (ITT) and Xerox Corp. (XRX), both of which returned over 80% for the year. A few of our other strong performers included Walt Disney Co,(DIS), Mylan Inc. (MYL), FedEx Corp. (FDX), and Life Technologies (LIFE). We sold this latter holding after a takeover offer was made for the company. Also performing well was one of our new holdings for the year, Hess Corp. (HES). We did have a few disappointments among our holdings. We sold World Fuel Services (INT) at a loss, and did not get the results we had hoped for from Teva Pharmaceutical (TEVA), Kellogg Co. (K), Timken Co. (TKR) or our Latin American consumer oriented stocks. These include BRF SA, (BRFS), Embotelladora Andian (AKO/B), and Grupo Pao de Acucar (CBD).

There was some activity in the portfolios, but overall turnover was fairly low. Among the stocks we sold were LIFE, INT (both mentioned above), and Microsoft Corp. (MSFT). New purchase included Barnes Group Inc. (B), Fidelity National Information Services Inc. (FIS), and Hess Corp. (HES). We also filled in portfolios in several instances with Adove Systems (ADBE), Corning Inc. (GLW) and CVS Caremark Corp. (CVS). However, these three securities were only bought when there was excess cash and were not purchased across the board for all accounts.

The obvious question is, where to we go from here? First of all, it just isn't as easy now as it was. We still believe stocks are on the inexpensive side and that economic growth should continue. However, the markets just aren't dirt cheap as they once were. While we're still remaining towards the upper end of equity limits, the fact is our clients were well exposed to equities at the beginning of 2013. In a year where stocks outperformed bonds by roughly 30 percentage points, it becomes clear that accounts that have a mix of equities and fixed income finished the year with even greater exposure to equities. So this year, we might see a little bit of pruning – not to reduce equity exposures per se – but just to rebalance closer to target allocations.

For 2014 we certainly don't expect the returns of 2013. There may even be a correction at some point. However, overall, we still favor equities over bonds or cash. The ride in in the current year, however, may be a little more bumpy.

Fixed Income Strategy

We define a pessimist as someone who is unhappy when he is wrong and even more unhappy when he is right. We've been pessimistic with respect to bonds for quite some time. A while back we cut fixed income exposures and shortened maturities in anticipation of rising interest rates. We admit, we became bearish way to early. But in 2013, the negative posture finally was correct. Last year, interest income often did not offset bond price declines. The Barclays Aggregate Bond Index declined approximately 2% in 2013. That decline nets the interest income and the change in price. Bonds with longer maturities declined in price in 2013 more than bonds with shorter maturities. However, this was partially offset by slightly higher interest rates.

Our concerns about bonds centered on more than higher expected interest rates. Our assessment was that in most cases we were not being compensated for the risk. A simple comparison might make the point. If the average interest rate on a portfolio is 7%, then if no more than 1/14th of the bond positions are wiped out by credit events, the income will offset the loss. However, if the average interest rate on a portfolio is 2%, then the income will offset complete losses if no more than 1/50th of the portfolio is wiped out. Now to be sure, even a total loss on 1/50th of a portfolio is not to be expected, but it certainly is with in the scope of possibilities – especially if one is buying individual bonds. Does anyone remember Enron or Lehman Brothers?

Still, given the improving economy, we thought it prudent to take on slightly more credit risk with bond positions and reduce, to the extent possible, duration risk (i.e., we kept maturities from being too far into the future). This was the correct stance for the year. We would have been happier if we were wrong in our pronostications, as that would have resulted in higher returns for our clients – even if our relative performance lagged. Yes indeed, it is no fun being a pessimist!

Looking forward, there is no easy answer here. 2012 closed with the 10 year Treasury yielding 1.76% and 2013 closed with that same bond yielding 3.02%. Unfortunately, we think rates can still climb higher. This doesn't mean the climb will be in a straight line or even happen quickly (though that might in fact be the case). The good news is that since most of our clients funds are not invested with long maturities, capital losses in 2014 should be subdued, while income might increase somewhat. Let us be clear. We are only talking about potential bond price declines associated with rising interest rates. We actually thing the environment with respect to credit risk is quite favorable. Still, at best we expect in 2014 low single digit returns, while negative total returns are possible.

So what's an investor to do? First, don't go chasing returns. It is proper for individuals to assess whether fixed income eposures should be lower. However, funds that are needed within approximately three to five years (there's no exact rule) should not be invested in equities. One also has to consider temperament. If you are likely to panic when things go poorly and sell your holdings (did you hold on when things got rouch in 2008 and 2009?), then you are also better off not changing your allocations.

Sometimes, the best strategy is to remain patient. The markets don't always offer the returns we would like. In time, available returns for fixed income investors will improve. We cannot predict how long that will take. While we await that future time, we strive to avoid (and suggest you likewise avoid) taking inappropriate risks in exchange for marginal improvements in yield. We want to protect our clients funds – especially those funds that are expected to be invested conservatively – so that when available returns are more appropriate, clients will be well positioned to take avantage of those opportunities.