Pinnacle Capital Management, LLC

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PCM UPDATE

Equity Strategy

The bull market in stocks continued in 2014. Following stellar returns in 2013, the equity markets continued to advance, with the S&P 500 generating a return of 13.68%. The year didn't start well, with the S&P returning negative 5.66% before it bottomed on February 3rd. Then it was clear sailing for several months. By July 24, the market was up 8.76% year to date. In the second half, volatility picked up a bit, with the market making three significant dips in each of August, October, and December. Each of these declines was followed by a rapid recovery.

It's hard to remember what investors were so nervious about, but we'll try to remind you. At various times the markets zeroed in on and then quickly ignored strife in the Ukraine, the possibility of rising interest rates in the U.S., economic weakness in Europe, fears of slowing growth in China, falling oil prices (yes, that has been considered a negative), and a rising U.S. dollar. All of these factors at one time or another were going to drive the U.S. back into recession – or worse.

One of the things we've observed is how emotional the markets have become. This applies to the broad markets, and individual securities as well. For example, on October 27th, Tenneco (TEN) reported 3rd quarter earnings, with EPS beating consensus estimates by 2¢ and sales missing by 0.41%. The stock promptly fell by more than 10%, closing the day down 7.83%. It was after this fall that we purchased shares for client accounts. Unfortunately, not all of these reactions occurred prior to our purchase for clients. While not in all accounts, during the year we began purchasing Rite Aid (RAD) where cash was availble. On September 17th, the stock closed at $6.64. The next morning the company announced earnings that beat expectations, though the outlook cited a tough pricing environment. Within a few weeks the stock declined to $4.51 for a 32% decline. On December 18th the company reported earnings that the markets liked. By year end the stock closed at $7.52, up over 66% from the bottom and 13% from the September 17th price. We assure you that the changes in the underlying fundamentals were not nearly as dramatic as the price movements.

And speaking of RAD, our health care investments overall performed well for 2014. While not all stocks are in all accounts, our investments in this area focused on expanding care and generic drugs. RAD and CVS Health Corp. (CVS) distribute health care through their pharmacies, while Mylan Inc. (MYL) and Teva Pharmaceuticals (TEVA) manufacture generic drugs. All four of these securites outperformed the broad markets last year. Other stocks that performed well include Intel (INTC), DirectTV (DTV), Walt Disney (DIS), EMC Corp. (EMC), FedEx (FDX). Other than EMC, we are not at this point purchasing any stocks from this latter group, as their prices have exceeded our buy limits. We actually have taken some profits in INTC, DTV, and FDX to purchase other investments.

Unfortuantely, this list of strong performers does not include for the most part our consumer, industrial, and energy holdings. ITT Corp (ITT), General Electric (GE), United Technologies (UTX), Mondelez (MDLZ), Kellogg (K), SAB Miller (SBMRY), Apache Corp. (APA), Hess Corp. (HES), and Terex (TEX) all underperformed the broad averages. And a coulple of our Latin American consumer holdings, Grupo Pao de Acucar (CBD) and Embotelledora Andina (AKO/B), underperformed as well. Much of this weaker performance occurred during the last quarter of the year. Meanwhile, we had no exposure to airlines, which were some of the top performers in the S&P 500. As a result, our overall equity performance lagged the broad markets. We've made some changes to portfolios, the most recent being our purchase of Apple, Inc. (AAPL).

Looking at 2015, the biggest changes are the rise of the U.S. dollar and the fall in energy prices. While there may be some reversal of either of these trends during the year, we do not forsee a return to January 2014 levels. Both of these changes benefit the U.S. consumer. Our thinking on individual investments and the markets in general will be reflective of this. Beyond those factors, there are other favorable tail winds that we like. First, equity valuations remain reasonable, and second the U.S. economy continues to progress. These bode well for stocks in general. With interest rates at such low levels, we still believe that equities remain the most attractive asset class. Having said that, markets are emotional. Unexpected turns always remain a possibility. Additionally, though we are not making such a forecast, it would not surprise us if stock volatility in 2015 exceeds the level experienced in 2014.

Fixed Income Strategy

For some time we've struggled writing the Fixed Income Stratey section of the Update. Finally we have something to write about, but it's not what we would have imagined. The year 2014, and in particular the last quarter, will be remembered for the steep decline in interest rates. Now the decline wasn't that large in absolute terms. But with rates already at low levels, the decline was very large in percentage terms. The 10 year Treasury rate, which closed 2013 at 3.03%, gradually fell during the year. By September 17th it stood at 2.62%, but then by year end it had fallen sharply to 2.17%. That's a 28% reduction for the year.

What precipitated the rapid decline in the 4th quarter were three interrelated events: falling energy prices, economic weakness in Europe, and a rising U.S. dollar. While we believe that growing supply is a major factor in falling energy prices, the markets have taken it as a sign of economic weakness – not just in Europe. While Europe's economy is weak, and the ECB (Europe's version of the Federal Reserve) will be providing monetary stimulous, fears about other nations' health accelerated. In particular, fears about economic growth in China became paramount. As a result of these fears the U.S. became a safe haven, driving the dollar upward. To a large extent it was Treasuries where that foreign investment flowed, thereby driving up prices and alternatively driving interest rates downward.

Ironically, all of this has occurred while the Federal Reserve considers when it should begin raising interest rates. Now the Fed has a great deal of control as to short term rates, but very little control over long term rates. So whereas it is unlikely for short term rates to go up absent changes in Fed policy, the longer term rates are much more subject to market forces. Right now, the global search for perceived safety and slightly higher interest rates has driven investment into longer term Treasuries. And, with the dollar rising, these investments are appreciating from a foreigner's perspective.

So where do we go from here? The unfortunate thing is that there are not a lot of great options. We have to accept low interest rates and try to squeeze out extra return where possible. We've avoided longer maturities. While we've given up profits as a result, the fact is unless we sell the investments before rates rise, the gains would be illusory. While rates could fall further, we do not think it is wise to speculate on such a move. If we are wrong, the impacts on portfolios would be detrimental.

As we've stated previously, we would rather keep maturities shorter, ranging from 0 to 10 years. Additionally, we've tried to increase returns by taking on some credit risk. By that we mean business risk of underlying companies. This is the same investment posture that we've held for some time. We're always on the lookout for new opportunities. However, we do not believe the fixed income portion of clients' portfolios is where we should be taking on significant risks. At this point in time, the upside just does not justify such a stance.