Pinnacle Capital Management, LLC

July 2013

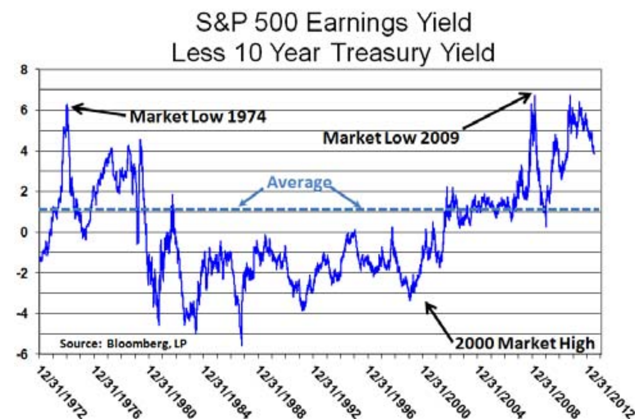
PCM UPDATE

Equity Strategy

The markets keep on moving upward – or do they. The S&P 500 inclusive of dividends generated returns of 2.9% and 20.8% for the quarter and year ended June 30th, respectively. However, after peaking on May 21, the index subsequently declined 3.5% by quarter end. In our Commentary, we discussed the pronouncements of the Fed and the short term impact on the markets. Still, we've had summer declines in each of the prior three years. Has the old "summer swoon" commenced?

Frankly, we don't know. It has always been our contention that it is impossible to predict markets, especiall in the short term. But what, then, accounts, for our generally bullish tone we've held for equities over the last few years? This bullishness goes to the heart of our investment approach. We view stocks as strictly ownership interests in ongoing businesses. Based on fundamental factors such as business strategy, stage in the business life cycle, barriers to entry, level of demand, competitive strengths and weaknesses, etc., we estimate underlying business values. In doing so, we take into additional consideration appropriate discount rates given current and expected interest rates, underlying levels of risk, and current and expected dividend payouts.

When we look at these valuations and compare them to current stock prices, we end up concluding that stocks are still somewhat undervalued, though obviously not as undervalued as they were last fall. We include nearby our favorite chart comparing the earnings yield (how much you get in earnings for every dollar paid) of the S&P 500 to the yield on 10 year Treasury bonds. Now it does not follow that just because stocks might be undervalued that they must continue their upward trajectory. Stocks can remain undervalued or overvalued for a considerable length of time. However, it has been our observation that over the long term, stock prices fluctuate around their true values. If one purchases securities below their actual values, and if those values remain stable or actually increase, the odds of investment success are significantly improved.



With respect to individual securities in the portfolio, there were few significant moves. On the upside, Life Technologies (LIFE) agreed to be acquired by Thermo Fisher. After the announcement, we sold the stock and purchased Fidelity National Information Services (FIS). FIS processes electronic payments such as those for credit and debit cards, and also provides software for banks and other finacial organizations to help run their back offices. Among our other holdings, Aflac (AFL), Intel (INTC), DirecTV (DTV), Mylan (MYL), Walt Disney (DIS), Caci International (CACI), and Apache Corp. (APA) all performed well for the quarter. Admittedly,

APA's recent performance follows signficant under performance in recent quarters.

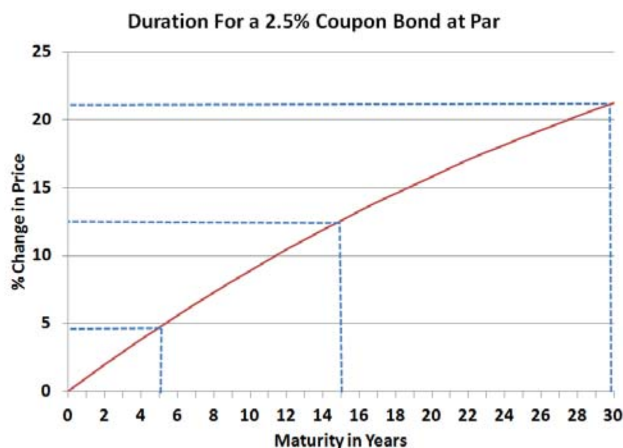
Stocks in the portfolios that did not perform as well include Embotelladora Andina (AKO/B), First Cash Financial Services (FIS), Groupo Pao de Acucar (CBD), International Business Machines (IBM), and SAB Miller (SBMRY). One common theme among the underperforers, excluding IBM, is that they were all impacted by weakness in emerging markets. AKO/B and CBD were particularly impacted by turmoil in Brazil. While we see this continuing for the short term, we believe the opportunities for growth in the consumer sectors in emerging markets to greate to ignore.

Fixed Income Strategy

We joked in our prior Update that we should have called that edition "Fooled Again". That is because after watching the 10 year Treasury yield rise from below 1.6% to nearly 2.1%, we watched the yield fall back down to just above 1.8%. Moving on to the most recent quarter, by mid April, the rate had dipped below 1.7%. However, we then witnesssed the 10 year yield rising back to 2.5%. Now we have been warning for some time that there was a strong risk that interest rates would rise. We've also suggested that investors should position themselves so that fixed income holdings were towards the low end of their tolerances. So once again, is this the great reversal we've been talking about? While it certainly feels like something has changed, we've been around way too long to make such an admant claim. Still, this is the first quarter in some time that fixed income investors are seeing losses in their portfolios of any consequence. The Barclay's Aggregate Bond Index lost 2.3% for the quarter. This measure of return includes the positive impact of interest. It will certainly be interesting to see if investors increasingly abandon bonds and drive prices lower.

So where does this state of affairs leave our clients? First, we have maintained portfolios towards the shorter end of the maturity and duration scale. This means that changes in interest rates, though having some impact on portfolios, will have a lesser impact than if maturities and durations were longer. Of course we recognize that this works in both directions. We've held this posture for some time. This has meant, unfortunately, that the fixed imcome portion of our portfolios have lagged the benchmarks whle interest rates have fallen.

To illustrate the impact of changes in interest rates on bond prices, we need to introduce the concept of duration. Duration, among other things, provides a measure of the percent change in a bond price given a movement of 1% in interest rates. Duration increases with maturity, and the chart below shows how increased maturity in years (across the bottom) impacts duration (vertical scale). The example is for a bond with a 2.5% coupon trading at par. So, such a bond with a 5 year maturity would rise or fall approximately 4.7% if interest rates moved 1%. But a bond with a 15 year duration would rise or fall approximately 12.6% with a 1% change in interest rates, and a bond with a 30 year maturity would rise or fall approximately 21.3% given a 1% change in interest rates.



From this example, you can see how sensitive bond prices are to changes in interest rates, especially as maturities are lengthened. Given low current bond yields, the potential for losses due to credit events, and the potential losses associated with changes in interest rates, we have not felt that it was prudent to position the portfolios with longer maturities – even if that meant we had to accept lower interest rates. While we are encouraged by the recent rise in interest rates, we do not feel it is yet time to extend maturities. In face this is exactly the point where we feel we should hold our ground. We will continue to protect portfolios from further potential increases in overall interest rates, though we recognize that exposes us to the potential of missing capital gains from any downward movements in interest rates. But to this we remind our readers of our old adage: When markets offer sufficient returns given inherent levels of risk, it is appropriate to pursue higher returns. However when markets do not offer sufficient returns given inherent levels of risk, it makes sense to forego higher returns and instead give greater focus to preservation capital.