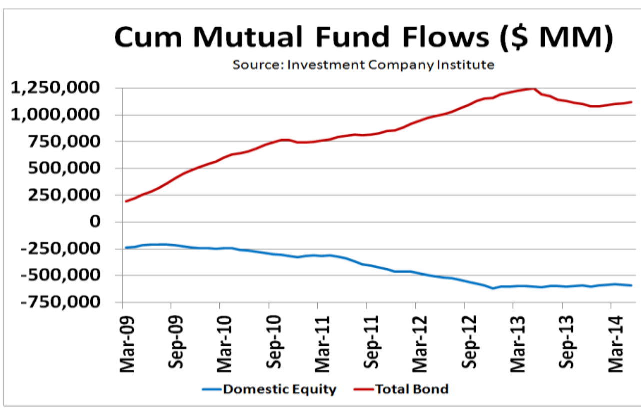
Pinnacle Capital Management, LLC

July 2014

PCM UPDATE

Equity Strategy

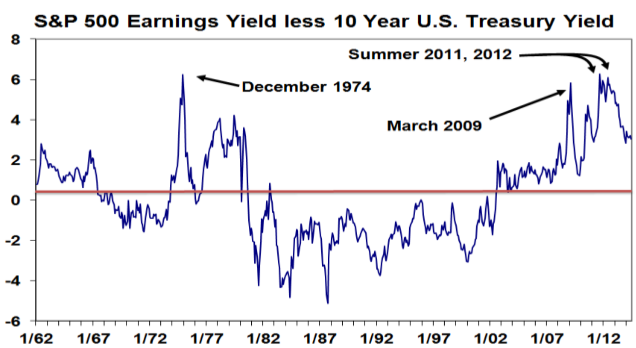
Investors still fear stocks, but the markets keep advancing. The S&P 500 advanced 5.23% inclusive of dividends through the first six months of 2014. Yet, there hasn't been a headlong rush into stocks. The chart nearby shows cumulative flows into both fixed income (red) and domestic equity (blue) mutual funds



since the bottom of the bear market in March 2009. What becomes apparent is that until the end of 2012, investors avoided purchasing domestic equity funds, while they strongly favored bond funds. Since then, the trends have reversed somewhat, there has been no apparent euphoria by individual investors.

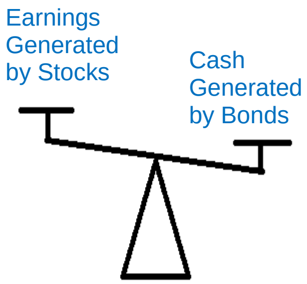
What is our position? We made the case in our Commentary that we expect continued slow economic growth. We note that as there is not too much capacity and final demand is expanding, we can expect a combination of modest unit growth and expanding margins for the near to intermediate term. Throw in just a touch of inflation and the outlook for corporate profits looks promising.

Of course we have to assess whether the markets are too expensive. To that end we trot our trusty and admittedly confusing chart comparing the earnings yield (how much in earnings you get per dollar of investment) on the S&P 500 to the yield on 10 year U.S. Treasuries.



To understand this chart, think of the difference between investing $1,000 in Treasury bonds where we'd get a cash return and investing $1,000 in equities where we get an earnings retrun. Wouldn't we want a higher return on our equity investment? After all, the earnings don't come in the form of cash (except for dividends) and there is more risk. But for much of the 1980s and 1990s investors required a lower return on stocks as measured by current earnings yield than they did on Treasury bonds.

Why would this be the case? It was so largely because investors had confidence that earnings would grow and create a much larger return in the future. For a long time this worked. However, after the dot com crash of 2000 and especially after the bear market of 2008, investors have demanded a higher return as measured by current earnings in stocks than they demanded in the form of interest from bonds. Our position has been that this represented an excellent situation. Not only do we get a higher rate of return than we would on bonds (admittedly in the form of earnings), but we also had confidence that earnings would grow generating higher returns in the future. The good news is that even after we consider recent rising valuations on stocks, the current earnings yield on stocks still exceeds that on 10 year Treasuries by roughly 3 percentage points. This diffenetial is high by historical standards. Given our confidence that earnings will continue to grow, our conclusion that stocks still represent a good value on the whole remains.



Our one caveat is that it just isn't as easy as it once was. While stocks in general might be attractively priced, more and more individual stocks are not. Additionally, investors are fickle beings. While they tend to be rational in the long run, in the short run they can be tremendously irrational. Herd mentality often overtakes sensible steps. For that reason, it would not surprise us at anytime if there were a correction in the market. However, that does not mean we should bet on such a correction. Instead, we need to maintain our long term focus. It has worked so far, and we are not about to change now… especially when the risk / reward characteristics remain so promising.

Turning to individual stocks, we had a number of stocks that performed well in client portfolios, and just a few stocks that performed poorly. Most notably our energy holdings, Hess and Apache, generated returns of 21.7% and 19.6%, respectively, after posting slight losses in the first quarter. Other stocks performing well include BRF SA (formerly Brasil Foods), SAB Miller, and First Cash Financial. These stocks were also among our worst performers in the first quarter, which makes us glad we didn't sell them. DirecTV continued to perform well, having received a buyout offer from ATT. As it is still below the intended take out price, we have not sold it. Other stocks continuing to perform well include ITT Corp and Xerox.

Among our poorly performing stocks, we include EMC, IBM, Caci International. All three of these are technology stocks. The sector did not perform well in the second quarter. While these are well established technology companies that had modest losses in the quarter, we avoided holding fast moving, cutting edge technolgy companies. Many of these fell spectacularly in the second quarter. It is important to remember that sometimes avoiding a big loser is as important as investing in a winner.

Fixed Income Strategy

It is frustrating for us to talk about Interest rates and fixed income strategy. While we have emphasized stocks over bonds (a good decision), we have also emphasized short duration fixed income over long duration instruments. This has not been the most profitable decision over the past few years. Our first objective is not to lose money. In that we have succeeded. But we recognize that our clients with fixed income exposures might have had higher returns had we extended maturities on their bond positions.

Why don't we throw in the towel and extend maturities now? To be quite honest, we can't justify such a move. The most recent Consumer Price Index report showed year over year inflation at 2.1%. We believe it will rise, albeit modestly. With the 10 year Treasury yielding just 2.53% at quarter end, it is difficult for us to justify investments in longer term bonds. At the end of 2013, the rate stood at 3.03%. That is a signifiant fall in the Treasury yield. As most interest rates correlate with Treasury rates, bond prices have advanced accordingly. For the quarter the Barclay's Aggregate Bond Index generated a return of 2.04% following a 1.84% for the first quarter. This is not a bad return for bond investors.

Of course, if rates rise, bonds could fall by similar amounts. That is what we have been trying to avoid. Given the paltry rates of interest on bonds, we still think it wise to avoid – or at least minimize – that risk. Though this hasn't been the best strategy to date, we intend to maintain that strategy going forward.

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