Pinnacle Capital Management, LLC

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PCM UPDATE

Equity Strategy

The sideways pattern we discussed in our last Update continued into the second quarter. The focal point of all action seems to be the future behavior of the Federal Reserve. The market tends to react negatively to strong economic news for fear that interest rates will go up. At the same times it reacts postively to weak economic news, since this reduces the liklihood of rates going up. This is, in our opinion, a case of the tail wagging the dog. The fear is higher rates will lead to a stronger dollar and make U.S. businesses less competitive – thereby hurting profitability. Lower rates, on the other hand, will make U.S. businesses more competitive. In other words, so the thinking goes, a strong economy is ultimately bad for busiensses and profitability, while a weak economy is better. Does anyone else see the twisted logic here? So, while the markets collectively agognize over such future directions, the tugging and pulling leads to the returns we've seen. For the second quarter the S&P 500 returned 0.27% and year to date 1.23%.

Diving deeper into the markets, what generated positive returns in the past quarter were primarily health care oriented stocks along with many technology companies. What lagged significantly were energy stocks and stocks of companies that supply the energy industry or were perceived to supply the energy industry. To that extent Mylan Inc (MYL) was one of the top performing portfolio companies as Teva Pharmaceuticals (TEVA), another portfolio company, persued its acquisition. Between quarter end and the writing of this update, TEVA gave up its pursuit of MYL and instead announced they had entered into an agreement to acquire a different company. While a portion of the gains in MYL were reversed, the value of TEVA since the announcement has appreciated. Another stock performing well was Pall Corp. (PLL), as it is being acquired by Danaher. Finally, in the takeover department, ATT's acquisiton of DirecTV (DTV) neared completion.

We didn't initiate a large number of new positions during the quarter, though we did take some initial bites of Fiat-Chrysler (FCAU) and added where funds were available some positions in Eastman Chemical (EMN). Despite some quality issues, FCAU has been gaining market share on a global basis as a result of strong sales of its Jeep brand. Meanwhile, EMN is benefititing from a solid economy and reduced costs as a result of the fall in oil prices.

And speaking of oil, on the one hand portfolios benefited as there were few direct holdings in oil companies. In fact, the only holding was Hess Corp (HES). While that limited energy exposure had helped, the markets continued to punish companies that served the industry. Despite serving a much wider market than just the oil patch, Terex (TEX) underperformed the markets significantly.

Among stocks not related to any of these themes, we were disappointed with the performance of Fidelity National (FIS). We do think this was just a temporary pullback during a steady advance. We haven't had any reasons to be concerned by the fundamentals. On the positive side, Embotelledora Andian (AKO/B) had a nice advance. This is a Latin American Coca Cola botteler that had declined in price significantly prior to the

quarter. We think this decline had been overdone as a result of perceptions about the Latin American consumer markets. We were glad to see the prior slide abate. Finally, we saw some nice performance by a few long term, core holdings including Mondelez (MDLZ), Walt Disney (DIS), and General Electric (GE).

Long term clients and readers will be used to us saying that the equity markets are the place to be. We still believe this is the case. However, finding good stocks to purchase is not the slam dunk that it once was. While the overall markets are reasonably priced, the best companies are often not cheap. Therefore, it becomes necessary for us to discern whether some of the less expensive stocks are that way because of misperceptions or because the outlook is less than robust. Obviously, we want those that are inexpensive but well positioned going forward. What we don't want to do is to chase good companies that are too expensive, nor purchase poorly positioned companies because they're cheap. As always, our disciplines are important, and we believe our long term focus will serve our clients well.

Fixed Income Strategy

We've discussed the Federal Reserve in our Commentary and again above in the Equity Strategy section. There's no need to repeat here (we can practically hear the collective sigh of relief by our readers). There's no doubt, the fixed income markets are a tough place to invest. Interest rates advanced somewhat in the quarter, and bond prices fell. The Barclay's Aggregate Bond Index's return was a negative 1.68% for the quarter. Most of the movement in bond prices was likely in direct anticipation of future Fed moves.

So where does this leave investors. We've been consistent in maintaining portfolios with maturities (more properly "duration")towards the shorter end of the specturm. We clearly would have been better off if we did not take this position as long ago as we did. However, we refused to chase returns by reversing this position as interest rates reached lower levels. At this point, at least, we think this has been the correct decision.

As we've stated at various times, the artificially low interest rates have in effect been a transfer of wealth from investors to borrowers. For example, we believe that given where we are in the economic cycle as well as underlying deficits and other issues, a 10 year Treasury bond should be yielding somewhere between 3½% and 4%, if not higher. Instead at quarter end the 10 year Treasury was yielding approximately 2.35%. And this was after the rate increased during the quarter. As other rates key off the 10 year Treasury, the impact has spread throughout the economy. On a $200,000 bond portfolio, this represents lost income of at least $2,300. This lack of companesation for a given level of risk has made our job considerably more difficult.

Unfortunately, we cannot dictate to the markets. We can only control the risk we take when we invest. In our opinion, taking on credit risk for the shorter term makes more sense than taking on duration risk (i.e., getting higher returns by extending maturities). And by credit risk, we're generally referring to corporations as opposed to government entitites.

As we look forward, we know that we need to focus on more than just the US economy. The economies of Europe as well as China can have major impacts. Finally, politics will (unfortunately) start taking on a more prominent role as 2016 nears. We still think the long term direction of interest rates will be up, and we will therefore continue to invest accordingly.