Pinnacle Capital Management, LLC

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PCM UPDATE

Equity Strategy

There's an old saying that Wall Street climbs a wall of worry. These thoughts keep coming to mind as we contrast the necessity of discussing one crisis after the other with the price appreciation of the markets over the past several years. We'll start with a table which illustrates our point.

TOTAL RETURN S&P 500 THROUGH 9/30/13				
	QTR	YTD	1 YR	3 YRS
Cumulative	5.2%	19.8%	19.3%	57.1%

Over these periods, how many times have we heard, "This recovery is faltering" or "This crisis threatens to plunge the world back into recession"? Is there something we see that no one else sees, or is there something else going on here? As much as we would like to claim some incredible expertise, we think the real issue is that the popular press – including the financial press – has no patience for research or analysis. Instead, sensational headlines apparently drive the reporting. This has both been reinforced by and reinforces our collective memory of the dot com crash and subsequent bear market of 2000 – 2002, as well as the 2007 – 2009 financial crisis.

It would be beyond the scope of this Update to do a thorough review of the cause of each of those two events. But summarizing, the 2000 – 2002 meltdown was caused by excessive valuations within the equity markets exacerbated by the impacts on confidence as a result of the September 2001 terrorist attacks. The 2007 – 2009 financial crisis and bear market were driven by excessive leverage outside of the equity markets, in part driven by policy responses to the prior bear market and recession.

Now it is not without justification that many are concerned with the strength of the current expansion. What is most often cited is excessive debt levels across many governments – particularly in the U.S. and Europe – as well as an anemic job recovery in these economies. We are actually more concerned with other items. In particular, we take notice of the impact on growth caused by deleveraging of balance sheets by individuals and businesses including financial institutions. We also worry about the distortions created by policy makers with respect to the price of money. Specifically, we are referring to the Federal Reserve and its European counterpart, the ECB. Contrary to the most popular opinions, we think the loose monetary policy, as opposed to "priming the pump" and driving equity prices higher, has hindered economic growth and equity price appreciation by simultaneously distorting incentives and creating uncertainty. While we obviously can't prove this point, we cite as minimal evidence the strength of the equity markets in the face of increased general sentiment that the days of Fed easing are numbered.

Despite these concerns, we have believed that the impact has been to dampen growth – not to bring it to a full stall. Given such an outlook, we have focused very much on market valuation. We won't go into much detail in this writeup. We will say, that according to our work, the valuations we are seeing on the market are those that we would expect to see if the 10 year Treasury yields were around 5% as opposed to below 3%. While individual stocks might have excessive valuations, overall we think the U.S. equity markets are not expensive. When we combine our valuation work with our outlook for continued modest economic growth, we still believe the equity markets are the place to invest for the long term. This doesn't mean all of our clients' assets should be so invested. Certainly needs for the near term shouldn't be invested in equities. But to the extent investors have tolerances for equity exposures that aren't absolutely fixed, we think they should consider investing towards the upper range of those tolerances.

Turning to client portfolios, returns generally were reflective of the broad markets. While most stocks appreciated and some performed impressively, the quarter was not totally devoid of disappointments. Several stocks had total returns of at least 10% for the three months. Leading the way were Mylan Inc. (MYL) with a total return of 23.0%, followed by ITT Corp. (ITT), First Cash Financial Services (FCFS), Hess Corp. (HES), and United Technology (UTX), all of which had total returns in excess of 15% for the quarter. While several stocks had returns which were roughly flat or slightly down during the quarter, we want to highlight two – Kellogg (K) and World Fuel Services (INT). Kellogg began the quarter slighly up, but revenues for the quarter ended June 30th were disappointing and the stock retreated. While there is definitely work for the company to do, we continue to hold the stock given its current valuation and long term prospects.

INT, on the other hand, we sold. We'll go into this as an abject lesson as to why investors should have diversification within their portfolios. INT is a broker of fuel to aviation, marine, and over-the-road markets. They're experts in logistics. On July 6, a train derailed in the town of Lac-Megantic, Quebec. Its cargo of oil exploded, killing nearly 50 people. This was an unfathonable tradgedy. And it just so happened that INT was in possession of that oil and they had leased the train that derailed (though they were not operating it). Needless to say, the stock took a hit, and we sold the stock promptly. Impacts on overall client portfolios were small. As we said, it is important to diversify, because there are just some things one can't foresee. Our thoughts are with the survivors and the families of the victims.

For most portfolios, we replaced INT with Barnes Group (B) at the end of the quarter. Barnes manufactures a range of industrial parts. Nothing sexy here; they produce mostly precision metal parts, and they have a strong presence in the automotive and aerospace markets. Barnes has been driving efficiency forward and culling their portfolio of offerings to focus on the most profitable sectors. With just over $1 billion in revenues, we think Barnes is one of those sleeper companies that will be able to keep chugging along for years to come.

Fixed Income Strategy

We've talked in the past about how it is more prudent to focus on preserving capital than on chasing returns when the available returns don't justify the risks. For the most part, this has been a sensible strategy – not just in the last quarter, but over the course of the year. While the 10 year Treasury began the year at a 1.75% rate and increased to 2.49% at the beginning of the 3rd quarter, it peaked at just over 3% intraday on September 5th. It has since retreated to 2.61%, but we still believe the long term trend for interest rates is up. Corporate bond rates have moved in a similar fashion, with 10 year BBB corporate bonds typically yielding 1.75% more than similar Treasuries. Still, we think that in most cases, the risk of rising interst rates is not offset by higher yields.

As we have also discussed, for the most part, we have kept durations short. This means that maturities and interest payments are expected to come in during the near term. As a result, bond positions (or the underlying bonds in a bond fund) are not so highly impacted by changes in interest rates. We have favored floating rate vehicles (interest on the securities move up or down with changes in interest rates). However, our use has been limited because most such securities – whether purchased directly or within a fund – have low credit quality. We strive to ensure sufficient diversification, but still we must limit exposure.

On September 27th, a 4.125% Freddie Mac bond held by many clients matured. While the replacement depended on individual circumstances, we added to our tool box the Vanguard Short Term Corporate Bond ETF (VCSH). In the past, we have emphasized the Vanguard Short-Term Bond ETF (BSV). VCSH is similar except that its focus is on short term corporate bonds while BSV has a much higher weighting towards U.S. Treasuries. We're trying to squeeze out a bit of extra return, but we have no desire to add signficantly to portfolio risk.

Going forward, we still foresee difficulties for fixed income investors. We see no easy answers. However, we think it's more prudent to wait for higher interest rates than exposing portfolios to excessive risk chasing returns. In layman's terms, we would rather be cowards who live to fight another day than die like heroes.