Pinnacle Capital Management, LLC

October 2014

PCM UPDATE

Equity Strategy

Last quarter, we began our update with these words: "Investors still fear stocks, but the markets keep advancing." Whereas the first part of that statement remains true and though the equity markets advanced in the third quarter (the S&P 500 advanced 1.13% inclusive of dividends), as our readers know by now the markets are no longer advancing. So let's address a few issues up front. In our opinion, what we are experiencing is a panic as opposed to a breakdown of the underpinnings of the market. By that we mean that a) we expect corporate earnings to continue to advance, b) that in general equities are attractively priced given our outlook, and c) given a, b, and the overall level of risk, we believe the potential returns over time remain attractive. Notwithstanding our opinion, collective fears are causing the markets to under emphasize the postive aspects of the current environment and focus almost exclusively on the negative aspects.

We were tempted to state that this is a correction as opposed to a bear market. But that distinction is only a matter of the degree of price movement. The markets are always emotional – especially in the short run. We cannot say how far down the markets will go before reversing, or whether we've perhaps already reached the bottom. Some may guess correctly, but always that's nothing more than a guess.

Our focus on the nature of the downward shift (a panic) as opposed to its duration (correction / bear market) is important, because it drives our investment position going forward. If we believed that underlying fundamentals were significantly deteriorating and / or prices were too high, we'd take a much more defensive position. We have to admit there are times that we consider making short term calls on the market. The difficulty is, even if we were correct and exited the market at an approriate time, then we'd also have to make the right call as to when we should get back in. If we failed to get back in at the approriate time, then even the decision to get out would likely result in poor outcomes for client portfolios. It is why we always focus on the long term. We're investors – not traders.

The difficulty of short term timing is more difficult than one might think, if merely because of the mathematics. Suppose our timing calls were correct 70% of the time. Then the odds of successfully getting out and back into the markets are 49% (70% x 70%). The odds of successfully completing this sequence two times in a row are 24%. Even if we were right 80% or 90% of the time, the odds would eventually work against us.

While we knowingly avoid making short term calls based on the emotions of the market, we recognize that in the near term client portfolios may be suceptible to shocks. In the current environment, stocks and sectors that are most sensitive to changes in the economy and prospective growth are being hit the hardest, whilst stocks with much less economic sensitivity have been somewhat more stable. Our client portfolios are positioned to take advantage of expected growth in the economy and corporate earnings. As such, our clients are experiencing the effect of the market panic.

While this is a frustrating development, especially with such recent acquisitions as Barnes Group (B), Terex (TEX) and in some portfolios Rite-Aid (RAD), we have

confidence in the outlook for all three companies as well as their valuations. On the other hand, some stocks generated nicely positive returns over the quarter. These include some of our technology holdings such as EMC Corp. (EMC) and Xerox (XRX). Unfortunately, as in past quarters where we had several stocks with strong returns such as as Mylan (MYL), Teva Pharmaceutical (TEVA), and DirecTV (DTV), there were a lack of such strong winners in the quarter to greatly offset our weaker stocks.

While we are clearly not satisfied with recent results, we do believe portfolios are positioned well. We believe one of our better attributes is our ability to remain calm and distinguish emotion from underlying fundamental changes. We saw similar market reactions in 2011 and even in 2012. As was the case then, we believe the wise course of action is to position portfolios for a modestly prosperous economic future.

Fixed Income Strategy

We tend to initiate these Updates several weeks prior to the end of the quarter. We develop our themes, note the trends, and lay out the basis of our discussion. In mid September, after watching the 10 year Treasury gradually slide to 2.34%, we saw that the market was finally appreciating an acceleration of the U.S. economy and an anticipated reduction of easing by the Federal Reserve. The 10 year Treasury had quickly popped to 2.63%. At that point we were all set to write about the impact of improved expectations in the fixed income markets.

Oops! By quarter end the Treasury yield had slipped back down to 2.49%. As market panic has set in during the first days of October, we're experiencing the lowest yields since early 2013. There are several explanations for such persistently low yields. We favor three of them.

First of all, when foreigners invest in dollars, they do not hold actual cash. Nor do they go to the nearest bank or credit union branch and open up a bank account. What they do is purchase U.S. government securities. In effect, the Treasury bonds become a currency in of themselves. This is very similar to the condition that existed well before the standardization of paper currency. People traded bills of lading and bank IOUs. This currency effect on bonds may be driving demand up for Treasuries and at the same time putting downward pressure on interest rates.

While this currency impact may be partially responsible for extremely low interest rates, we think a greater impact is the failure of the Federal Reserve's easing policies. We say failure because the intent was to inject liquidity in the economy, thereby stimulating economic activity. We believe this easing has largely had the greater effect of providing banks with cash with which they immediately turn around and invest in Treasuries. In effect, the Fed is just buying Treasury bonds via an extremely circuitous route. This buying pressure puts downward pressure on interest rates.

Do these two factors fully expain the current level of interest rates? As a gauge, other than times of recession, the 10 year Treasury yield tends to approximate nominal GDP – that is, the rate of real GDP growth plus inflation. Given the latest readings of 2.6% year over year growth in real GDP (the latest quarterly figure was signficantly higher) and 1.7% inflation year over year, one might infer a 4.3% 10 year Treasury yield. We believe the fact that yields are so much lower requires the added explanation of a recessionary mentality. Obviously, rates have held much lower than we ever imagined. We find it interesting and even a bit confusing (notwithstanding the two factors explained above) that such a pessimistic outlook has persisted in an expansion which is currently in its sixth year. We have remained optimistic with respect to stocks over the past five years. During that period of time we've expected and have experienced an increase in stock prices as both earnings have progressed and fear of renewed recession began to fade. Why this fear and flight to safety still persists in the fixed income markets we just can't say.

Likewise, we can't say when the turn around will arrive; but when it does occur, rates might accelerate quickly. We are still avoiding long maturities, but are not adverse to taking on a small amount of credit risk to slightly enhance yields. The available returns are still not where we want them to be. Unfortunately, one can only take advantage of the opportunities that are there. One cannot create returns in a risk appropriate manner where such returns do not exist.