Pinnacle Capital Management, LLC

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# PCM UPDATE

## Equity Strategy

Equity portfolios and the equity component of mixed portfolios generally appreciated in the context of an up market. For the three month and nine month periods ended September 30, 2016, the S&P 500 returned 3.85% and 7.84% respectively. While we are pleased with the positive returns, it is also true that performance for the month of September was generally weak, representing a setback.

For the quarter and the year to date, positive results were led by our investments in technology stocks. Apple (AAPL), CACI International (CACI), Fidelity National Information Services (FIS), and Plantronics (PLT) all outpaced the markets. Meanwhile, EMC Corp. (EMC) was acquired by Dell in the last quarter.

Our client portfolios also maintain significant investments in the auto industry including Fiat Chrysler Automobiles (FCAU), Ford Motor Company (F), and auto parts manufacturer Tenneco (TEN). A strong impetus for these investments is that TEN, FCAU, and F are trading at levels that suggest a sharp recession in the automobile industry. We believe this is overly pessimistic. So far, results of our strategy have been less than what we like. Subject to when clients joined us and cash availability, we generally have profits in F and TEN. Meanwhile, FCAU is still showing significant losses based on our initial purchases.

Other consumer product and service companies showed mixed results as well. Consumer stalwarts such as Mondelez (MDLZ), Unilever (UL), and Kellogg (K) generated small, single digit percentage losses in the quarter, though the latter two are still positive for the year. We attribute no particular problem to these holdings. Sometimes, sectors just don't always move upward. Our newest long position, Kroger (KR), replaces EMC in the portfolio following its acquisition. We purchased this holding in the context of a downward movement in the stock in anticipation of an eventual turn around. The stock has been plagued by disappointing sales. In the meantime, profits have been growing nicely. What is going on here? Very simply, food inflation has actually turned into food deflation. What we believe so many miss is that KR's costs are declining as well. To give a simple illustration, the markets should not care if an apple which cost $1.00 and was selling for $1.50 last quarter now sells for $1.40 at a cost of $0.90 or sells for $1.60 at a cost of $1.10. In all these cases, the profit is $0.50. Yet the market is fixated on the top line issue. In fact, the spread has been widening as the price has fallen. We are attempting to take advantage of this misperception. We can't be sure when the market will come around to our way of thinking, but we expect it will eventually see things as we do.

Now, let us discuss our real Achilles Heel when it comes to performance - our health care holdings. Unfortunately, one of our largest holdings is Mylan, manufacture of the EpiPen. For those of you not paying attention, the company and the product have been attacked vigorously in the press and in Congress for their pricing practices and Medicare reimbursement classifications. We will not go into detail here - there's just not enough space. But let's put a few things out there. First, all is not as is being reported. Nonetheless, the company has at a minimum blundered badly. Second, while the drug is generic, the delivery system - the EpiPen - is not. The patent expires in 2018. Revenues and prices were never going to be sustained more than a few more years, and this is not an unknown to investors. Third, the timing could not be worse. We are in the midst of a presidential election cycle, and there is no way the pressure will let up soon. Fourth, the stock has lost in market value a multiple of the revenues of the EpiPen since the story became public.

We are left in a very uncomfortable position. The profits will be impacted. Yet the stock has sold off way too much given that loss. As we are finalizing this Update on October 10, we are strongly encouraged. Mylan stock is up over 8% today following its announcement that it is settling with the Department of Justice with respect to overcharges in the amount of $465MM. That settlement equates to approximately $0.87 per share and is a small fraction of the recent loss in stock market value. Though this doesn't resolve all issues, and may make politicians even angrier, this goes a long way towards putting the issue to bed.

Before we leave the subject completely, the negative situation with respect to Mylan has impacted the stock price of its nearest competitor, which is also held in most PCM client portfolios. Our investment in Teva Pharmaceutical has also lost money in the quarter and year to date period. The sentiment with respect to the drug and health care sector is currently very negative, especially with the election coming soon. Notwithstanding this issue and the situation with Mylan, the current environment may present us with real bargains.

The final sector we'd like to mention is telecom, and we hold in most portfolios Verizon Communications and / or AT&T. While the returns have been very strong year to date and have outdistanced the broad market returns, in the third quarter these stocks gave up a portion of those gains. We attribute this partially to the slightly positive move in interest rates, partially to simple profit taking, and partially to recurring fears about damage due to price wars in the phone business. As we have said in the past, we think these fears are overblown with respect to the potential impact on profits.

## Fixed Income Strategy

We discussed the Federal Reserve to some extent in our companion Commentary. As we stated in that piece, in the absence of Fed Funds rate increases, the general level of interest rates declined over the course of the current year, though they have risen from the low midyear levels. At quarter end, the 10 year Treasury stood at 1.59%, up from 1.47% at midyear, but still down from 2.27% at the end of 2015.

We see the possibility of an increase in the Fed Funds rate as being very slight by year end. The outcome of the election and political environment will have a strong impact on what happens in 2017. Still, our current thinking is that we can expect one, or possibly two, 0.25% rate hikes in 2017. Time will tell.

Having said all of this, we do want our clients to be prepared for reality of the impact on portfolios if interest rates rise. As rates go up, the value of the investments on the fixed income side of the portfolio (either individual bonds or bond funds) may likely fall. However, the reality of this is that our clients will also likely be better off if this happens. Why? The answer is that we will be able to reinvest income at higher interest rates. This increased income, though small at first will likely outweigh the impact of immediate negative returns from rising rates over a typical 10 year period. Of course, there is no guarantee things will work out so favorably (the element of risk, changes in risk perceptions, and changes in portfolio have an impact), but we do think in the end clients will be happier.