January 2016

PCM UPDATE

Pinnacle Capital Management, LLC

Equity Strategy

Let's start with the good news. In the 4th quarter of 2015 equities generally performed well. The S&P 500 returned 7.03% for the quarter. However, given the volatility in the markets, it seems that a discussion of the quarter must be viewed in the context of the entire year. 2015 was a difficult year, indeed; and 2016 has not started well. The S&P 500 finished down slightly for the year, but returned 1.37% when dividends reinvested in the index are considered. While performance varied for individual clients, client portfolios generally appreciated in the 4th quarter. For the year our client performance, for the most part, lagged the S%P 500 benchmark. Needless to say we are not satisfied.

So where did we go wrong, and where did we go right? The greater part of the performance lag occurred prior to the 4th quarter of 2015. Therefore, we think it important to reiterate some of the themes we discussed in the October 2015 PCM Update. First there was oil. Despite remaining underweight oil with one long position (Hess Corp.) performance was negatively impacted by the reaction of the markets to stocks that supply the oil industry. While one might expect this, industrial companies whose revenues are only partly attributable to the oil industry lost considerable value. Case in point: ITT Corp. Despite only generating 20% of its revenues from the oil industry ITT returned -16.63% for the first 3 quarters of 2015 vs. -21.40% for the iShares Oil & Gas Production ETF and -5.29% for the S&P 500 Index. Likewise, chemical companies, which utilize hydrocarbons as an input lost value in the first 3 quarters. Many portfolios hold Dow Chemical Company and / or Eastman Chemical Company. And speaking of Dow, the company is merging with DuPont with the intent of spinning off 3 separate companies focused on different lines of business. There was a brief bit of euphoria upon the announcement, but the stock has backed off since. Still the stock returned 24.4% in the 4th quarter. This restructuring, we think, is only good news for the company and reinforces our stock price target.

The second disappointing sector was auto and related. Many accounts hold Fiat Chrysler, Ferrari NV (spun off by Fiat Chrysler at the beginning of 2016), and Tenneco Inc. We had held Borg Warner as well, though it was sold. 2015 was a record year for auto sales. Good news? We're afraid not. All these stocks fell as the Volkswagen scandal took hold. Now Borg Warner would be hurt by damage to VW, so we sold it. But none of these others stocks should have been impacted. Fiat Chrysler now has a market cap of approximately $10 billion with revenues of about $120 billion. Tesla Motors, a company not owned in portfolios, had revenues of less than $4 billion in 2015. It has a market cap double Fiat Chrysler. Go figure!

Another sector mentioned was health care. Most accounts hold, Mylan NV, Teva Pharmaceuticals, and possibly retailer CVS Health. We did hold Rite Aid, but we sold it on the announcement of an acquisition by Walgreens. Though Mylan performed extremely poorly in the first three quarters, the stock rebounded by 34.30% in the 4th quarter. We're obviously happy with that - though we still think there is considerable upside.

Teva Pharmaceutical also performed well. While ITT (discussed above) bounced back somewhat in the quarter, other industrial holdings such as Barnes Group lost noney. We were very happy with the returns of General Electric, returning 24.44% in the quarter, while our Latin American holdings continued to perform poorly. These holdings include BRF SA (-21.34%), Embotelladora Andina (-15.57%), and First Cash Financial Services (-6.57%). While this latter company is a U.S. company, First Cash generates more than 50% of its revenues in Mexico.

Finally, defensively oriented companies generally performed in line with the markets. Verizon, Kellogg, Mondelez, SAB Miller, and Unilever all had returns for the 4th quarter in the mid single digits.

Before we close our discussion of equities, we'd like to share our thoughts about early 2016. This has been a dismal beginning to the New Year. Markets are incredibly nervous, especially regarding China. We believe the fear might be overdone, but it wouldn't surprise us if stocks continue to slide for a while. Having said that, we are not market timers. Nor have we met anyone who has profitably invested based on all the swings in the market. What we can say is, though the road may be bumpy, valuations are generally reasonable. In individual cases, valuations may be absurdly cheap or absurdly expensive. Eventually, stock valuations tend to work their way out. All the while we'll stick to our disciplines and attempt to add value in the most prudent manner we know how.

Fixed Income Strategy

Well, they finally got up the nerve. The Federal Reserve took the momentous step and raised their target Fed Fund rate by a quarter of a percent. Our belief is that had they not done so, they would have lost all credibility. And while they've targeted four increases for 2016, the most likely case is that there will be two increases or less. There may be none.

Treasuries fluctated throughout the year, but essentially, the rate on 10 year T Bonds was flat. Interest rates on corporate paper rose somewhat, so prices on those bonds fell correspondingly. Importantly, the bond markets truly hated risk in 2015. While prices on investment grade bonds fell modestly, prices on below investment grade fell significantly more. To some extent, this was due to fears regarding the ability of marginal oil producers to service their debt in the face of falling oil prices. But to a larger extent we think the issue was fear itself. Many investors had chased higher returns in 2013 and 2014 by investing in below investment grade bond funds without fully appreciating underlying risks. Intolerant of fluctuating prices, many liquidated their mutual fund holdings as 2015 progressed. The funds were then forced to sell many bond positions to cover redemptions. This selling pressure force bond prices lower, creating a viscious cycle. As a result, yields are now very atrractive in many cases as we see it.

Our clients do have and have had exposure to these markets, primarily via the Fidelity Floating Rate High Income Fund and the SPDR Barclay's High Yield ETF. These funds did lose value in 2015, though they continued to pay dividends. We stated in our October 2015 Update that we feel this sector is one of the few where we can still get reasonable returns. While we acknowledge a soft economy, we are of the opinion that the problems we're experiencing in 2016 are nowhere near the problems of 2007 - 2008.

And therein lies the heart of many of the problems we see in the markets today - not just in the bond markets, but for the stock and commodity markets as well. Fear, more often than not, is winning over rationality. The question we face as investors is whether to play to this fear or continue to invest on a rational basis. While it might make sense to some that we should just recognize the fear and invest accordingly, it must be understood that market emotions can change on a dime. Overnight the fear could just subside. Or there could be a shift to excessive exhuberance. We believe recognizing the underlying fundamentals of the economy and individual companies is a much better strategy.

So, as we see it, rates remain too low; though it may be some time before they increase signficantly. We will, for now, continue to position a significant portion of clients fixed income investments in instruments focusing on shorter maturities. And, we'll continue to invest at least a portion of client funds in fixed income investments with exposure to business and credit risk. The markets are frustrating - both the bond and stock markets. Especially in times like these, we believe continued focus on the long term is essential.