WOODSTOCK

QUARTERLY NEWSLETTER

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On this front page we try to emphasize and highlight why you, our clients, should be at Woodstock. Because our goal is a reasonable, equity-like return compared to the S&P 500, not an extraordinary return on invested assets, nor a muted enhanced bond return, we highlight several things. First, we highlight the quality of our investment management professionals. Our investment managers must research companies, build portfolios and keep good client relations. Generally our managers maintain a relatively high active share[1] in the accounts they manage so if things go right our accounts get a pop. Second, our back office, Woodstock Services Company, maintains a custody and accounting system, and tax services to some of our clients, that emphasizes a high level of service at a reasonable cost. And third our structure as a company owned by its clients tries to assure that overall our efforts are meant to satisfy our clients. A reasonable business proposition. And then sometimes it benefits from a pop.

Eight years ago we began investing in having our performance measured in accordance with the industry standard, GIPS. We didn't try to play games with structure. Most of our clients want an equity-like return which we bench mark as 80% S&P 500 and 20% Barclays Aggregate bond index. Approximately 80% of our assets under management fit that profile and are included in one composite. However, within that 80% some clients give their managers free reign and others have some restrictions relating to withdrawal of funds, a family/business related stock they wish to own, or very low basis securities with a high hurdle for selling. We decided to leave all these varied accounts in one composite with really one profile, our growth composite.

As most of you know, it has been very hard for active managers, like Woodstock and most mutual funds, to beat passive investing, the index funds. Historically only 40% of active managers have beaten their bench mark and in 2014 the expectation was that only 20% would.[2] In a way the debate between active and passive is the wrong debate. The real question is what do you want to harness your investment portfolio to? If it is a basket of 500 stocks, most of which you wouldn't buy on a stand-alone basis, then go ahead. However, if as the investment world keeps repeating, prior results are not indicative of future results, then prudence would say, beware. To quote, "there are no dependable ways of making money easily and quickly, either in Wall Street or anywhere else".[3] If we as active managers work hard to find good, high quality companies at reasonable prices to include in our clients' portfolios then at some unexpected time that may be an extraordinary strategy. Mathematically, staying close to your bench mark with the potential to have one extraordinary year means that not only the single extraordinary year but your 3, 5 and even 10 year performance may be very favorably impacted. Many investors embracing the endowment model of investing also hope for this phenomenon to occur. However, they hope to protect on the downside to reap that 3, 5 or 10 year benefit, by not going down as much in down years. The consequence of that strategy, however, is to model and plan for an "enhanced bond return", which historically has been a very different and depressed return compared to an equity-like return.

For this big build up, what have we done? For 2014 our growth composite has beaten its bench mark not only gross, but net of fees for the third year out of the last four and the second year in a row. The equity component beat the S&P 500 Index by over 150 basis points, a significant margin. A pop! The last time we had an extraordinary year was 2000. It has been very hard work to maintain our structure and dedication over 14 years to be able to deliver these results to our clients, again. Everyone at Woodstock and its related companies is very proud to have been able to do it.

Please feel free to call or email either of us with questions, comments or concerns regarding Woodstock.

We thank you for your support and want you to know that we are dedicated to serving your best interest.◆

William H. Darling, Chairman

Adrian G. Davies, Executive Vice-President & CIO

[1] *"active share" is a portfolio that looks different than its bench mark, in our case the S&P500, and is a mathematical measurement. Ask your portfolio manager for the reference.*

[2] *WSJ 12/27-28/2014*

[3] *Benjamin Graham quote, WSJ 8/23-24/2014*

Three Key Developments in Financial Markets

Adrian G. Davies

U.S. equities enjoyed another good year in 2014. The S&P 500 Index was up 13.7% including dividends, following a year in which it was up 32.4%. The market has generated returns of 14.8% per year over the last 5 years. Even if investors had invested in stocks at the peak of the market (about October 31, 2007) before the Great Recession, they would still have seen 6.3% annualized returns through year end 2014.

Three key developments in the financial landscape in 2014 have implications for 2015. The developments were not completely unrelated. First of all, interest rates fell when most forecasters thought they would rise. In a Bloomberg survey early in 2014, 100% of forecasters thought interest rates would rise,[1] and yet the rate on the US 10-Year Treasury fell from 3.03% at year end 2013 to 2.17% by the end of 2014. If nothing else, the pundits' (and our) missed expectation shows the hazards of forecasting. We were optimistic that the stock market would rally, if not under the precise circumstances that were realized.

The search for yield drove global investors to park more assets in US denominated debt securities. Even though yields are quite low by historical standards, US Treasuries have higher yields than most other developed country sovereign debt. Some German bonds are trading at negative yields. Most forecasters did not foresee the outbreak of disinflation driving down rates worldwide. Continued disinflation in turn stemmed from disappointing economic growth overseas. Geopolitical instability in the Ukraine and Iraq didn't help the situation.

The second important financial development in 2014 was the collapse in the price of crude oil. The price of West Texas Intermediate Crude fell 52% from $105 per barrel at the end of June to $53 by year end. Oil fell because new shale production in the US increased supply, while demand around the globe disappointed expectations.

With the notable exception of oil producing regions and countries, cheaper oil ought to stimulate economic growth. Lower prices for oil and its derivatives should mean consumers have more income to spend on other things. According to one analyst, the drop in the price of oil would mean the equivalent of a $150 billion dollar tax cut to US consumers.[2] The fact that shale development has been an important driver of economic activity over the past several years makes it difficult to estimate the net benefit to the US economy. The decline in the price of oil is of course a global phenomenon, suggesting at least one reason economic growth worldwide should improve in 2015. One risk is that low prices create political instability for regimes of oil export dependent economies.

While the decline in oil prices may be explained by the increase in supply at least as much as demand weakness, oil is not the only commodity that has fallen. Copper, steel, and most grains also fell in 2014. Commodity price declines were in part due to the strengthening of the US Dollar, but most prices moved down more than the Dollar moved up, suggesting that the supply glut extends beyond energy, and softening global demand is quite possibly a factor. Through much of 2015 we should continue to see this economic shift benefitting consumers of commodities to the detriment of commodity producers.

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Inflation Rates – Consumer Price Indices around the World

Source: Bloomberg

The third key development was that the US Dollar rallied 13% on a trade-weighted basis in the back half of 2014. The rally was driven by divergences in economic growth rates and divergences in monetary policies. While the U.S. Federal Reserve appears poised to tighten, other central banks around the world are either easing aggressively or moving towards easing. Quite possibly the broader global monetary backdrop is helping the U.S. market. If monetary easing policies are successful in reaccelerating economic growth, everyone benefits. One caveat is that the stronger Dollar can be expected to dampen U.S. export demand, presenting a mild headwind to growth. Exports constitute about 14% of U.S. GDP, lower than for most developed economies. Another caveat is that corporate earnings could be impacted more than the U.S. economy, with companies in the S&P 500 Index generating an estimated 35%-40% of their earnings overseas.

Where do these three economic trends leave us in 2015? The good news is that the U.S. economy appears to be on a much stronger footing than it has been in years, having grown at an average rate of 4.1% over the last three quarters. The country is creating jobs at the strongest pace since 1999. It's certainly possible that growth in the US may slow, but it is equally reasonable to think that growth outside the U.S. will reaccelerate. More stimulative monetary policy and lower commodity prices support the possibility of economic reacceleration.

Oil prices and the US Dollar are notoriously cyclical – the trends will remain in play until they reverse. Industries are adjusting to current oil prices – consumers will incrementally consume more and producers will curtail production. The fallout in oil is likely to claim some casualties, with high cost producers defaulting on their debts. Efficient operators will eventually emerge stronger.

Fortunately, the combination of very low inflation and central banks fighting the fear of deflation has proven to be good for stock markets. We can hope that will continue. If central banks were to win their battle with disinflation, the investment climate would change. Central banks around the world would welcome the reappearance of some inflation. We would most likely see mild inflation, which probably would mean global economic growth strengthens and the environment would be favorable for stocks. Inflation means at least some companies have pricing power.

At 16x 2015 earnings, the S&P 500 Index is no longer inexpensive, but it's not expensive either. The above-average multiple may be justified in light of low interest rates -- alternatives to stocks may be less attractive. P/E multiples could move even higher as long as interest rates stay low. In an ever-constant sea of uncertainty, we believe the Woodstock approach of managing diversified portfolios of high quality stocks is the best way to generate long term returns. As always, good stock picking and careful risk management will matter. ◆

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[1] *Eisen, Ben, "100% of economists think yields will rise within six months," Marketwatch, MW Blogs – The Tell, April 22, 2014.*
[2] *Rublin, Lauren L., "Masters of the Game," Barron's, January 18, 2015.*
[3] *Benjamin Graham quote, WSJ 8/23-24/2014*

Tax Update

Jeanne M. FitzGerald

Many taxpayers with incomes exceeding certain thresholds were surprised to learn the full impact of the new net investment income tax on their 2013 tax liability.

Effective January 1, 2013, individual taxpayers are liable for a 3.8 percent net investment income tax on the lesser of the taxpayer's net investment income or the amount by which their modified adjusted gross income exceeds a threshold amount of $200,000 ($250,000 for married taxpayers filing jointly and $125,000 for married taxpayers filing separately).

In general, net investment income is the excess of the following items of income less any deductions that are properly allocable to items of gross investment income:

1. Gross income from interest, dividends, annuities from unqualified plans, royalties and rents
2. Other gross income from passive activities
3. Net gains attributable to the disposition of property other than property held in a nonpassive trade or business

Examples of gains includable in net investment income include gains from the sale of stock and securities, mutual fund capital gain distributions, gains on the sale of investment real estate, and gains on personal residences that do not qualify for the exclusion.

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An individual may exclude from gross income up to $250,000 of gain ($500,000 if married filing a joint return) realized on the sale or exchange of a principal residence if they meet certain ownership and use requirements. This exclusion also applies to the net investment income tax.

Wages, unemployment compensation, operating income from a nonpassive business, social security benefits, alimony, tax-exempt interest, self-employment income, and distributions from certain qualified plans are examples of types of income that are not considered net investment income. However, a distribution from a qualified plan that is includable in gross income is taken into account for determining the taxpayer's modified adjusted gross income in the net investment income tax calculation.

Trusts and estates are subject to the 3.8 percent net investment income tax on the lesser of a) the undistributed net investment income and b) the excess of their adjusted gross income over the dollar amount at which the highest tax bracket begins for the tax year ($12,150 for 2014). The undistributed net investment income is the trusts or estates net investment income reduced by distributions of net investment income to beneficiaries and by certain deductions.

The net investment income tax is separate from the new additional Medicare tax which also went into effect on January 1, 2013. The 0.9 percent additional Medicare tax applies to individual wages, compensation, and self-employment income over certain thresholds. It does not apply to income items included in net investment income.◆

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We are growing and accepting new clients. The best clients are the ones that come from a referral. Please consider recommending us.