WOODSTOCK

QUARTERLY NEWSLETTER

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In the past we've briefly discussed asset allocation, other investment strategies and the benefits in both up and down markets of high quality growth stocks. However something is missing in our presentation and we think we should be clear about what we mean. If you and your investment manager have a clear understanding of your cash needs over the next two years, we believe that our core product, high quality US stocks and equity bond substitutes can be used for 100% of your investment portfolio. This is true for many of our clients and for asset sizes from one million dollars to twenty million dollars and up.

We think we need to be clear because there is some confusion in the general financial services market place on how to balance "diversification" with trying to receive an "equity-like return". Our contention is that you can diversify yourself away from an equity-like return into something like an "enhanced bond return" by investing in too many asset classes. As discussed last quarter our benchmark for our Growth Composite is a static blend of 80% S&P 500 and 20% Barclays Aggregate Bond Index. We believe that's an equity-like return. We believe that you need to take the good years with the bad and don't try to time the market to receive the benefits of our strategy. Remarkably high quality US stocks turn out to be good protection, as well as provide a good return. As you know, your tolerance for risk should determine your bond exposure.

We have a client at Woodstock whose father-in-law brought him here. He reminds us that there must be some "fun" in investing. Whether it is a small company or two that you like the sound of, one of our strategy accounts, an actively managed Chinese equity fund, a pre-venture capital investment fund for start-ups, or a natural gas mineral rights investment vehicle, there is fun to be had and we can provide it or show you where it can be found.[1] But we believe that at least 80% of your assets should be in our core product. Also, on the grander scale, "fun" can be having your whole account increase by double digits in one year.[2]

We've also been talking about the changes we'll be making at Woodstock and one of them has occurred. After ten years of leading Woodstock, Pete Simpson retired as President on March 6, 2013. Pete was appointed President on March 5, 2003 and has steered the company through some difficult times, attracted a very high quality staff to Woodstock, and set us on a course to a very successful future for our clients and for the company. He has helped design a company that benefits when its client do. We need you to succeed financially to prosper ourselves. As an interim measure the Board of Directors has appointed William H. Darling, currently Chairman, as President and Adrian Davies as Executive Vice President and Chief Investment Officer. Pete has retained some investment duties at Woodstock, has been appointed Vice-Chair of the Board and will work part-time at our sister company, Agawam Trust & Management, LLC.[3]

We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow.

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 and President
Adrian G. Davies, Executive Vice-President & CIO

[1]These are examples of investment vehicles that are in existing Woodstock clients accounts.
[2]See last quarter's Quarterly Newsletter.
[3]Please visit our website www.woodstockcorp.com for additional information on individuals, companies and services.

The Same Old Cycle, But With A Twist

Adrian G. Davies

Guiding the US economy with monetary policy is like steering an oil tanker ~ it takes an awfully long time to turn the ship about. There are always multifarious forces at work on the economy, but the Federal Reserve has more influence than most. Monetary policy changes tend to affect the capital markets quickly, but tend to affect the underlying economy over a more drawn out period. This was particularly true after the financial crash that occurred in the Fall 2008 and Spring 2009. To the extent that the Fed is at the helm, it often over-steers the tanker, underestimating how policy changes will impact the economy through the next phase of the economic cycle. Since monetary policy impacts the economy with a long lead time, waiting for economic data to prove the need to change policy means that economic trends often get extended well beyond what is appropriate for stable growth.

In the Fall of 1998, the Fed cut interest rates by 0.75 percentage points to stem market nervousness in the aftermath of the Asian currency crisis, the Russian Ruble default, and the restructuring of hedge fund Long Term Capital Management. Arguably, the easier monetary policy was one factor contributing to the technology stock bubble in 1999. From June 1999 through May 2000, the Fed decided that monetary policy had been too loose and raised rates by 1.75 percentage points. Rising rates was possibly the prick that burst the technology bubble. The result of course was a 50% market decline from 2000 through 2002. Similarly, keeping interest rates very low after the technology bust was one factor contributing to the housing bubble in 2006 and 2007. The Fed kept the federal funds rate low through June 2004, and then raised it in 0.25 percentage point increments until it hit 5.25% in July 2006. While it would not be fair to blame the Fed for the ensuing recessions, with hindsight, it appears that the FOMC (Federal Open Market Committee) committee members over-reacted to current conditions, not fully grasping how their actions would play out in a changing economic environment.

During a typical monetary cycle, the Fed tries to make money cheap and readily available. For the last 30 years, the Federal Reserve has set progressively lower interest rate lows with each cycle. The cycles of interest rate cuts in 1989 and 2000 eventually led to market recoveries. In both cases, the recoveries were driven at least in part by rising home prices. Cheaper mortgage rates meant that more people could afford homes and that they could afford larger ones. This cycle we hit rock bottom ~ the fed funds rate is effectively zero. The Fed implemented quantitative easing (QE) programs to stave off the Great Recession of 2008. QE can be viewed as a continuation of the interest rate cycle, but in a new form since zero represents a natural limit on how low interest rates can be set.

When the Fed implements quantitative easing, it buys US Treasury securities from participating banks. In exchange for the Treasurys, it credits the selling banks' reserve account at the Fed. The Fed creates the credit it uses to buy the bonds, in effect printing money. If the banks lent money against their excess reserves held at the Fed, the money supply would expand. One reason we haven't seen rampant inflation is that banks are not lending as fast as their reserves are growing. Another reason QE has not prompted more inflation is because there is so much underutilized capacity and high unemployment. Economic growth would probably have to absorb these underutilized resources before inflation could take hold. The Fed was looking at a GDP output gap of approximately 7% ~ that is, GDP was approximately $1 trillion below its potential ~ when it decided to implement its first round of quantitative easing.

Inflation expectations remain fairly low, and the economy seems to be generally recovering. Last August, Fed Chairman Bernanke estimated that the Fed's first two rounds of quantitative easing boosted GDP by 3 percentage points and created 2 million US jobs. Regardless of the drivers, housing is recovering, with home prices up 8.1% year-on-year according to Case/Shiller. However, tax increases and budget reductions look to be a 1.5%-2.0% headwind to growth this year. Still, thanks to housing and a broadening recovery, the US economy can still make net gains. The economy should see stronger growth in 2014 as we put fiscal tightening behind us.

Every market cycle has some unique characteristics. This one is no different. The 1999 cycle was in technology stocks. The 2007 cycle was primarily in home prices. Having these two cycles fresh in their memories, investors this time around are playing it conservatively. Not wanting to be duped by another bubble, they have been buying bonds.

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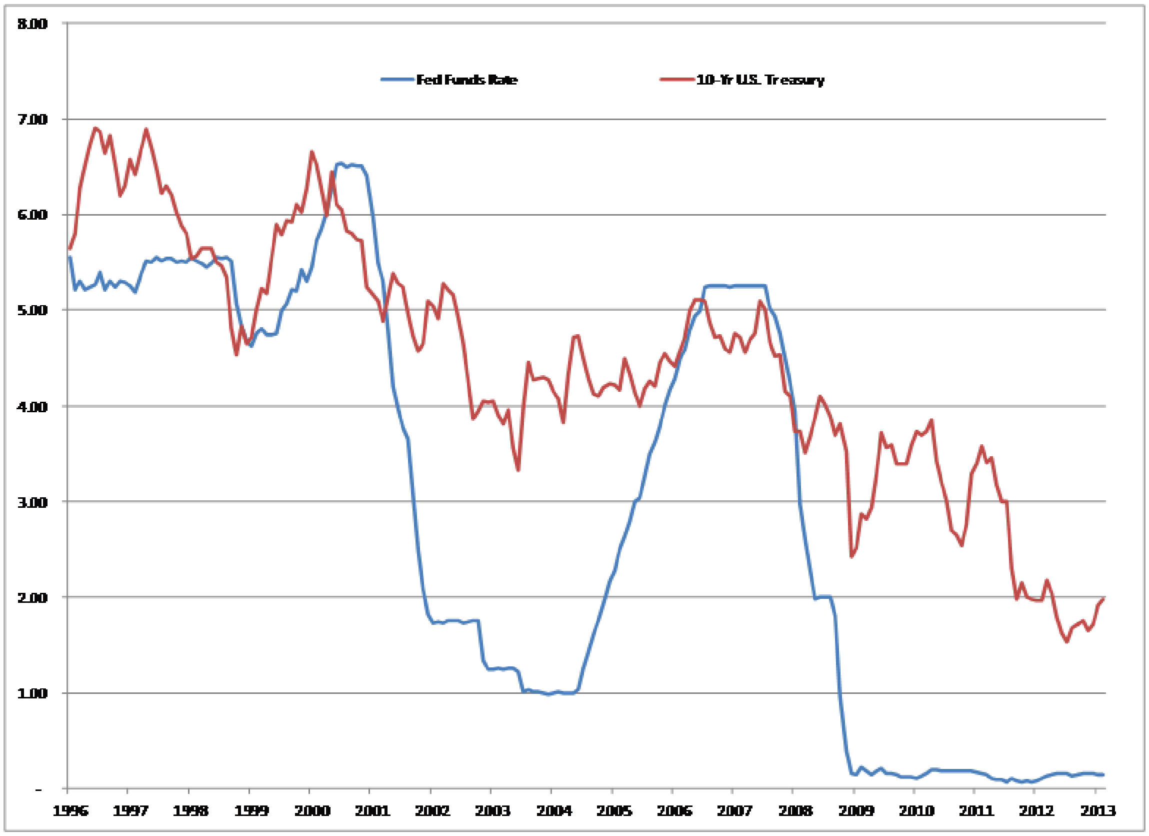

Source: St. Louis Federal Reserve Bank

Market prices of bonds have outperformed stocks as interest rates have fallen. However, bond investors can expect to get no more than their principal back plus a fixed interest rate. For investors holding bonds until maturity, lower interest rates mean lower prospective returns.

Bond yields are extremely low by almost all measures, approaching some of the lowest rates recorded over the past 400 years. Interest rates on most US Treasury bonds are below the current level of inflation, suggesting that investors are locking-in negative real yields unless we see outright deflation.

Both the Fed's bond purchasing program and concerns about tepid economic growth are helping to keep interest rates low. The Fed wants to keep rates low, making it less expensive to borrow, and they hope that low rates will drive yield-deprived investors into riskier assets such as stocks. Rising home prices and stock prices produce a "wealth effect" – making people feel better about spending and thereby boosting economic activity. However, the Fed's aggressiveness itself is making many investors cautious. Investors are concerned that the Fed's stimulus is temporary and therefore artificial. They understand that monetary easing will only last until the economy recovers.

Normalizing interest rates will require an extremely delicate balance. The Fed will almost certainly open itself to criticism one way or the other – tightening too quickly or keeping monetary policy too loose for too long. Tightening too quickly would cause asset prices to fall and would choke off the economy recovery. Waiting too long would lead to inflation. Bernanke has made it clear that he would rather tolerate some inflation than choke off the recovery. He is focused on the counter-example of 1937, when the Fed increased bank reserve requirements at the same time the government was tightening fiscal policy. After a promising few years of economic recovery in the mid-1930s, US GNP fell 11% from its 1936 peak.

This time around the Fed may not want to make the determination of when to raise rates. The Fed shifted its policy communications from being calendar-focused – communicating its intent to raise interest rates in mid-2015, to being outcome-focused – raising interest rates either when unemployment falls to 6.5% or when inflation is sustained above 2.5%, whichever comes first. Part of the reason for the change in communications strategy is to encourage market participants to make up their own minds about the pace of interest rate increases rather than waiting for edicts

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from the Fed. The Fed may then choose to follow the market's expectations.

The bond market should anticipate the Fed's next move. While the Fed is a major buyer of longer maturity bonds, they have limited their participation so that market prices will at least partially reflect the expectations of other market participants. Forward curves (not shown) currently anticipate that the Fed will raise rates in mid-2015. As seen on the accompanying chart, 10-year rates did a better job of leading fed funds rates in the 1999-2002 market cycle than they did during the 2006-2008 cycle. Historically, the yield curve (in this case, the 10 year Treasury minus the federal funds rate) has been an important early indicator of recessions. By this measure, we are far away from a recession now.

It is unclear how rising interest rates will impact the stock market and the economy. Bond yields probably won't increase until either economic growth or inflation expectations accelerate. Because high unemployment and underutilized factory capacity are deflationary forces, inflation is unlikely to rise until there is some economic reacceleration.

With bond yields so low, many investors are concerned that rates will rise suddenly. Once bond investors decide interest rates are rising, they may rush for the exits. If bond prices fall and interest rates rise too rapidly, the resulting credit contraction could choke off economic growth. But faster economic growth is precisely the reason that rates would rise. Slower economic growth should therefore drive bond prices back up and interest rates back down. Rates may be more volatile in the near term, but over a longer period of time they should be self-moderating.

Another concern is the extent to which the stock market is supported by QE. If stocks were propped up by QE, one would expect valuations to be high. Even as the S&P 500 Index reaches new highs, it is trading at a P/E multiple of about 14.3x current year earnings, below its historical average. Earnings have grown faster than stock prices.

QE is designed to move investors from safe investments into riskier investments. It has a stimulative effect on the economy, which the markets are trying to anticipate. If the economy were to relapse or stock prices were to fall from here, there would be all the more pressure on the Fed to increase the amount of money put into the system. The Fed will most likely continue to implement quantitative easing until the economy has demonstrated an ability to grow on a sustainable basis. The Fed has turned the helm and the oil tanker is starting to respond. The bigger risk may be that the oil tanker shows momentum well beyond what the helmsman had intended. ◆

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The Family Office Revisited

Henry P. Phippen

We have asked our related company, Agawam Trust and Management, LLC ("Agawam") to discuss its business. Their services provide an alternative to bank trust departments, law offices, or other trust offices and we thought you would be interested.

Agawam Trust and Management, LLC ("Agawam") serves as a family trust office for two core families, each currently consisting of three generations, soon to be four, and two other, related families each covering two generations. For these families, Agawam principals assume the role and fiduciary responsibilities of a lead trustee. Agawam is currently offering similar services to other unrelated families as trustee consultants. Usually, these families provide their own trustees and Agawam would deliver the fiduciary support services necessary for this demanding family job.

So, what is Agawam and how does it function? It is a fifth generation family office operated as a family trustee cooperative. Each of the trusts managed by Agawam has multiple trustees, with at least one of the Members of Agawam serving as a lead trustee. All of the other trustees delegate to their co-trustees, who are Members of Agawam the authority to manage the day-to-day activities of the trust. On behalf of their co-trustees, the Agawam trustees shoulder the responsibility borne by all trustees regardless of delegation for carrying out the fiduciary duties to the trusts and their beneficiaries. The Agawam trustee acts as the point person for the trust.

As lead trustees, the focus at Agawam is to foster an environment of partnership among the Donor, the trustees, and the trust beneficiaries. In addition to understanding the Donor's intent, clear communication with the beneficiaries to educate them of the trustees' responsibilities and duties within the framework of the trust instrument is

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paramount in assisting to guide the beneficiaries' expectations. It is of utmost importance to relate the family's values towards inherited assets and to mentor and teach beneficiaries about wealth responsibilities, as well as to understand and plan for the emotional and potentially disruptive content of family assets. Although a core goal for clients is wealth creation and preservation, the ultimate focus is on stewardship of the assets for future generations.

For beneficiaries who are coming to the age of majority, Agawam discusses and helps to guide the decisions necessary (i.e. choice of executors, guardians, trustees, healthcare agent, etc.) in the creation of wills, revocable trusts, and health care directives, and acts as a liaison with an estate planning attorney to draft the documents on their behalf. For clients at this stage of life, it is an important part of our proactive multigenerational guidance to assist the beneficiary in building their financial competence and to teach them how to manage their financial responsibilities. Collaborating with them to create an annual budget, as well as teaching them the benefits of credit management is a great start.

For beneficiaries of any age, Agawam has valuable knowledge of estate planning practices and opportunities and is proactive in advising on strategies to take advantage of annual exclusion and other gifting, philanthropic pursuits, or updating documents to reflect new circumstances, such as marriage or the birth of a child. Again, we act as a liaison between client and legal counsel, allowing us to frame the issues with the client prior to engaging legal professionals. This results in a highly efficient and more economical outcome for our clients.

For clients who are concerned with "who will take care of things when I die," Agawam trustees, if not appointed as executors themselves, are available to help coordinate and facilitate the duties of the executors, as needed. The process of filing court documents, having assets valued, analyzing and quantifying trust provisions at death, preparing estate tax returns, and other responsibilities at the end of life is a complex undertaking that is best handled in an efficient and competent manner. For many of its trusts, Agawam provides annual cash flow reports which allow the trustees to concisely quantify the impact of various inflows (i.e. dividends, tax refunds, capital additions) and outflows (i.e. taxes, distributions, fees, charitable and family gifts) on the accounts and their valuations. This report is prepared in a five page presentation, analyzed by the lead trustees, and reviewed with the beneficiary, either directly in a meeting or indirectly through the discussion of related topics.

The lead trustee meets periodically with Woodstock investment managers to review asset transactions, liquidity needs, and asset allocation guidelines for the trusts. In addition, all Agawam trustees meet monthly with the investment managers to review equity holdings, investment performance, and recent transactions of a rotating group of accounts in detail, and to discuss other trustee business. Each quarter at these meetings, investment performance is reviewed and quarterly spreadsheets that document year-to-date trust market values are prepared and reviewed. In addition, on an annual basis similar spreadsheets are prepared that document the December 31 valuations for each trust since the mid-1990's. These annual valuation reports, in concert with the cash flow reports, help to guide the trustees and beneficiaries over the long term.

Agawam provides a high level of service in an individually customized, client-focused manner. We have benefited from the over 80 years of family trust experience, and continue to share this knowledge with the next generation and with others. We offer similar fiduciary services to unrelated clients, not as sitting trustees but as consultants to other existing or potential family trustees who do not have the time, expertise, or store of knowledge that may be required.

Agawam's goal is to provide our clients and future clients with a feeling of well-being, knowing that they have a trusted advisor who will advocate for their best interest at all times. ◆

Henry P. Phippen is a Director of Agawam Trust and Management, LLC. You may contact him at hphippen@agawam.com.

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