WOODSTOCK

QUARTERLY NEWSLETTER

In This Issue:

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Looking at a chart of interest rates[1] from 1945 to 2012, it is almost a perfect mountain. From just under 2% in 1945, it rises to 16% in 1981 and is down below 2% in 2012. Of course interest rates jumped around during that period but the overall impression is gradually up, then gradually down. Where are we now? Down. What's the investment impact when rates gradually move up? Not good. Financial instruments bought when interest rates are low will probably lose value as interest rates rise, certainly bonds and annuities but stocks will face headwinds as well, particularly dividend paying stocks held as bond substitutes.

We can see this coming, so how do we prepare? Our investment philosophy helps. We prefer to buy shares in companies with strong growth prospects and that meet other high quality characteristics.[2] If we buy during the growth phase of a company's development, we hold until the end of that phase or until the other high quality characteristics change for the worse. Other investment philosophies can require more than one buy and one sell decision and can be more difficult to appropriately time.

Many financial markets' returns prognosticators believe that the recent run up in stock market values has already captured much of the upside. The lowered return expectations over the next 5 to 7 years is forcing many institutional investors, searching for greater returns to meet spending targets and inflation expectations, to invest in hedge funds and private equity. We believe that there are two kinds of "hedging": one is more like buying insurance; the other is unacceptably increasing risk through investment vehicle selection or by using leverage. In the first case, as with insuring other activities, it is just a cost benefit analysis. Does the cost of the insurance seem reasonable compared to the risks that might be protected against? Because riskiness is often associated with or defined as volatility, many of the insurance strategies involve containing volatility. Most of those strategies are available to Woodstock portfolio managers and we have a client or two who use them. We'll also have a more formal offering in the next six months or so which we'll describe to you in a future issue. On the other hand, the "black box", or "you can't look inside", hedging too often masks an investment that is unacceptable to many investors if made alone or with leverage. Romanian bonds come to mind and result in raising the risk of loss to unacceptable levels for most investors.

While we are now at an unsettling economic time, for the first time in a long time the annual financial return expectations for high quality US stocks exceed the annual return expectations for large cap US stocks (S&P 500) by 400 to 500 basis points over the next seven years.[3] This may not come to pass or we may miss it through a fault of our own but we will try to capture that difference for you and for us. It will be hard work but this is what this firm has been built to do.

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] 10 year US Gov't Bond.
[2] Strong balance sheets, good market position and capable managements.
[3] For viewing on a prominent investment manager's website. Please contact your PM.

Don't Fear The Taper

Robert A. Davidson

The U.S. Stock Market has undergone a 6% correction from May 21st to June 24th as the U.S. Federal Reserve has indicated its willingness to taper its bond purchases later this year. This has led to an increase in the ten year U.S. government treasury yield from 1.77% to 2.5%. The rising ten year yield has led many commentators to discuss the imminent slowing of the U.S. economy and increased fears that the economy might slip back into recession. The usual perma-bears are out with their usual discussion of Armageddon. We feel these fears are overdone and that this recent pullback presents an attractive opportunity.

There are many reasons to believe the U.S. should continue in a relatively slow growth, low inflation environment that would be conducive to good stock returns. Let's begin with the positives of the U.S. economy.

From a non-governmental structural point of view the U.S. economy is in excellent shape. Corporations still have in excess of two trillion dollars on their balance sheets earning a very low return. The U.S. consumer has taken their debt level from 130% of income in 2007 to 107% at the end of 2012. The consumer confidence reports have improved most likely as a result of slightly better employment figures, stock market gains, and recently, a much better housing market with prices up 10-15% year over year. Despite recently rising mortgage rates housing affordability is still historically strong and housing should continue to be a positive for the U.S. economy.

In addition to housing there are short term positives for the U.S. economy. After a weak March-May period, the four June regional business surveys from the Fed districts of Dallas, New York, Philadelphia and Richmond have been strong. The average corporate index jumped from -4.8 in May to 8.7 in June. The average orders index rose from -3.2 in May to 8.0 in June.

As mentioned, consumer confidence has rebounded from 72.5 at the end of December to 82.7 in June according to the University of Michigan survey.

In addition to shorter term measures there are other long term structural reasons that the U.S. economy should continue to grow.

1.) The fracking revolution has made the U.S. a low-cost destination for energy-intensive industries. The price of natural gas is 80% lower in the U.S. than it is in most other places. This makes the U.S. very cost-competitive in attracting new industries.

2.) The abundance and low price of U.S. natural gas has created an opportunity in the country to be a net energy exporter which would be very positive for domestic economic growth.

3.) The U.S. auto fleet is at a record average age of 11.1 years. There is substantial pent-up demand for vehicle replacement that should provide a tailwind to economic growth for the next several years.

4.) In its early years ObamaCare, despite its chilly effects on employment discussed below, will probably be a positive for economic growth. The reason for this is that it creates 15-20 million new customers for all aspects of health care. As we all heard during the discussions of the pragmatic merit, healthcare is roughly 20% of GDP. With newly created customers – not to mention new coverage mandates – there are significant growth opportunities for 20% of the GDP. As with all governmental programs we will worry about paying for it at a later time.

5.) The U.S. is still the world leader in technology. This will provide many other growth opportunities.

Offsetting these factors and arguing for a rather muted U.S. growth rate are the following:

1.) ObamaCare is very detrimental to job growth. Employers across the country are very uncertain as to what their costs will be as a result of the new mandate. As a former independent businessman in Massachusetts, upon whose program the national program was based, over two years insurance cost per employee increased 90% and the total cost per employed increased 14%. If this is replicated nationwide it will be a significant deterrent to hiring.

2.) International fragility is still a concern.
a. Europe is showing signs of stabilizing but remains in a no or low growth environment.

Continued on Page 3

Europe-wide unemployment is 12.5% and much more severe in peripheral countries. In addition, European banks are still woefully undercapitalized, with the OECD estimating the banks' capital deficit between 300-400 billion Euros. Little to no structural reform has been implemented. It is likely that the Euro region will bounce along the bottom for the foreseeable future.

b. The BRIC countries (Brazil, Russia, India and China) are also faltering. In Brazil, India and Russia the acceleration in redistributive or confiscatory policies has weakened the appetites of foreign direct investors. In addition, the return to prevalence of extensive corruption has also had a deleterious impact. In the case of China, the government seems to be attempting to cool speculation in the banking sector. This has led to a slowdown in growth. As many will recall, the BRIC countries were a major theme for international growth in the past decade. An adjustment period for all will lead to slower international growth and lower commodity-based inflation. Japan, now the third largest economy, is the one bright spot in the international scene.

3.) Sequestration has been a drag on economic growth and should continue to be for the next several quarters. Yardeni Research estimates that government spending cuts are currently the difference between a 2% rate of GDP growth and a 3% rate.

4.) Commodity prices, other than oil, have been decimated. While this is positive for keeping inflation low, it is a negative for economic growth. Especially in emerging countries, the oversupply implied by plunging prices makes the case for capital investment very weak and is another argument for weak global economic growth.

The sum of the evidence would indicate that the U.S. economy should continue in a slow-growth environment with very limited inflationary pressure. As a result it is unlikely the Federal Reserve is about to embark on an aggressive program to raise borrowing costs. What is more likely is that the Fed will buy fewer bonds, letting the longer duration rates rise (as they already have) but keeping short rates near zero until the U.S. and world economies are stronger.

A positive yield curve has very good implications for some U.S. industries and is not a bad environment for stocks. We expect the environment to last for at least 18 months. With stocks selling at a reasonable 13x forward earnings, selected equities could do well in this environment.

We think the comments of Janet Yellen (likely next chairwoman of the Fed) sum up our outlook. "We are not talking about slamming the brakes," she said recently. "We are just easing up on the accelerator." With bond prices coming down, commodities weak and still plentiful liquidity the stock market, after a period of adjustment, is likely to look like the best asset class available. ◆

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Contributions to a Traditional Investment Retirement Account

Jeanne M. FitzGerald

Individual Retirement Accounts (IRAs) are among the most popular retirement vehicles. The following highlights some of the common mistakes that individuals make with their IRAs.

Not making "catch-up" contributions: In 2013, individuals may contribute the lesser of $5,500 (or $6,500 if age 50 or older) or the individual's compensation. Individuals age 50 or older may make "catch-up" contributions of $1,000 per year to their IRA.

Making excess contributions: A 6-percent excise tax applies to any excess contribution to IRAs. An excess contribution may be corrected without penalty if the excess is withdrawn before the federal tax return filing due date, including extensions. Any earnings attributable to the excess contribution must also be withdrawn.

Not taking required minimum distribution: Required minimum distributions (RMD) are minimum amounts that a traditional IRA account owner must withdraw annually. The first distribution must be made by April 1 of the year following the year that the owner reaches age 70 ½, the required beginning date. The distribution schedule is determined using the Uniform Table set forth in the Treasury Regulations. If the full amount of the RMD is not distributed, the undistributed amount is subject to a 50% penalty tax. A distribution from an IRA that is less than the RMD is

Continued on Page 4

subject to a 50 percent penalty tax. The difference between the RMD and the amount actually distributed is subject to the penalty. Making two required minimum distributions in the same year: As noted above, individuals may delay the receipt of the first distribution until April 1 of the year after they reach 70 ½. However, subsequent required minimum distributions are due by December 31 of that year. If the first distribution is delayed to the following year, there will be two RMDs taxable in that year. This may push the recipient into a higher income bracket and incur more total tax.

Failure to rollover IRA funds within 60-days: A rollover is a method of moving an individual's assets between various types of retirement plans. The rules may vary depending upon the type of rollover. An indirect rollover occurs when an individual takes a distribution from his or her IRA or from a qualified plan and transfers the assets to another IRA or another qualified plan. The indirect rollover from a traditional IRA to a traditional IRA must be completed within 60 days to continue to defer the recognition of income. An additional 10 percent tax generally applies to any withdrawals made before the owner reaches the age of 59 ½. A direct rollover occurs when the assets are moved directly from one financial institution (IRA custodian or retirement plan trustee) to another financial institution. The 60-day rule does not apply to direct rollovers.

Failure to name or update IRA beneficiaries: The distribution rules for IRAs depend on the class of beneficiary (IRA owner's surviving spouse, an individual other than the surviving spouse, the IRA owner's estate, charities and trusts) and whether the IRA owner died prior to receiving required minimum distributions from the IRA. It is important to name primary and contingent beneficiaries to ensure that the assets of the IRA pass directly to the intended recipient. The ability to defer recognition of income and to allow the funds to grow tax-deferred are some of the advantages of IRAs with proper beneficiary designations. IRA owners should review their beneficiaries regularly or at least when a significant life event occurs.

The rules governing retirement plans are numerous and complex. Financial professionals can assist you in navigating these rules so that you avoid costly penalties and achieve your financial goals. Please contact our office with any questions regarding your retirement planning or other financial objectives. ◆

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