WOODSTOCK

QUARTERLY NEWSLETTER

Fall, 2013

We have written in the past about our core product (a strong allocation to high quality US stocks), asset allocation (for an equity-like return), the future of the investment management business (focusing on our clients' needs) and our investment style (trying to be safe and rewarding in down and up markets). We have invested in the people, both front and back office, and systems to provide outstanding results and service to our clients. Our three year returns in absolute terms are spectacular and we know the 80% of our clients' funds included in our growth composite have participated within a very narrow range of dispersion in that success.[i]

In This Issue:

Slow and Steady Wins the Race

Strataweb Update

Tax Update

Now what? The battle for your, our clients', hearts and minds is on. How can we repeat the last three years' results over the next three? And the companion question: what investment styles are positioned to do better? As we discussed last quarter a major investment management firm on its website predicts high quality US stocks performing 400 to 500 basis points better than the S&P500 stocks each year for the next seven years and on a par with other, more diversified asset categories. Also, unless world governments, and particularly the US, start encouraging private sector growth through tax rate reduction, budget priorities and spending restraint we expect to perform well for macroeconomic reasons. The worldwide lack of encouragement for private sector growth is perversely very fertile ground for the US stock market to perform well in. So to narrow the question, in the future when private sector growth is encouraged, why be in our style and at Woodstock?

The answer that shines a positive light on Woodstock is that all participants agree that the value of assets drives market pricing over the long term. Exceptional managers blend accumulated, and some proprietary, research with portfolio construction in a way that allows them to leverage their best ideas while maintaining sound risk management. Portfolio construction talent is often the most challenging attribute to identify and includes position sizing, entry and exit timing, sector rotation, and prioritization of investment ideas. This is what we do. Very few of us are left that are not hedge funds. The above description, in fact, was of an "ideal", and hard to find, hedge fund.[ii]

The answer that shines a less than positive light on the alternatives and how they will perform is that they are expensive, rare and have had sub-par results since 2008. Specifically, the asset allocation areas that have survived the last five years and still look promising are hedge funds and private equity. Hedge funds seek downside protection, to zig when others zag and to seek broader opportunities for profit. However, if all that translates into just market timing in areas highly correlated with public markets then the long-term success will be as poor and expensive as the last five years.[iii] Private equity returns are heavily influenced by timing; a 2 to 3 times your money return over five years is very different from 2 to 3 times over 10 plus years.[iv] With central banks controlling asset prices, private equity is now being stretched to the 10 plus year scale. Also, fees are an interesting comparison. If the ideal hedge fund is charging 160 to 180 basis points before incentive fees and the astute consumer is willing to give up an extra 25-50 basis points over alternatives to participate,[v] then that theoretical alternative is still much more than the Woodstock fee which includes custody.

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
Adrian G. Davies, Executive Vice-President & CIO

[i] *Ask your portfolio manager for an explanation and copy of our Growth Composite. Published in last quarter's newsletter.*
[ii] *Ask your portfolio manager for the reference.*
[iii] *Ask your portfolio manager for the WSJ reference.*
[iv] *Doubling your money over 10 years is a 7% annual return.*
[v] *Same reference as ii*

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Woodstock Corporation: Growth Composite

	Annual Returns Periods Ended 31 December				
	2012	2011	2010	2009	2008
Gross of Fees	12.43%	4.66%	9.24%	18.58%	-29.43%
Net of Fees	11.31%	3.62%	8.14%	17.39%	-30.14%
Benchmark	13.66%	3.45%	13.67%	22.46%	-29.83%

Note: Returns are measured in U.S. dollars

Woodstock Corporation claims compliance with the Global Investment Performance Standards (GIPS®). Woodstock Corporation is an investment advisor registered with the Securities and Exchange Commission under the Investment Advisors Act of 1940. Registration does not imply a certain level of skill or training. Woodstock Corporation manages a variety of equity, fixed income, and alternative investments for high net-worth individuals, trustees, corporations, and philanthropic institutions.

Performance has been reduced by the amount of the highest fee charged to any client employing the strategy during the performance period. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. The firm's fees are available on request and also may be found in Part 2 of its Form ADV.

The composite consists of portfolios seeking long-term growth, while minimizing turnover and taxes. The composite consists of portfolios typically comprised of 70-100% equity instruments. The composite benchmark is a static blend of 80% S&P 500 and 20% Barclays Aggregate Bond Index and is rebalanced monthly.

Portfolios may fall outside target allocation due to volatile markets, but will remain in respective composite if they maintain the long-term goal.

To obtain a compliant presentation and/or a list of composite descriptions, contact Elena Gillespie at egillespie@woodstockcorp.com.

Composite and benchmark returns reflect the reinvestment of dividends and other earnings. Past performance does not guarantee future results.

Slow and Steady Wins the Race

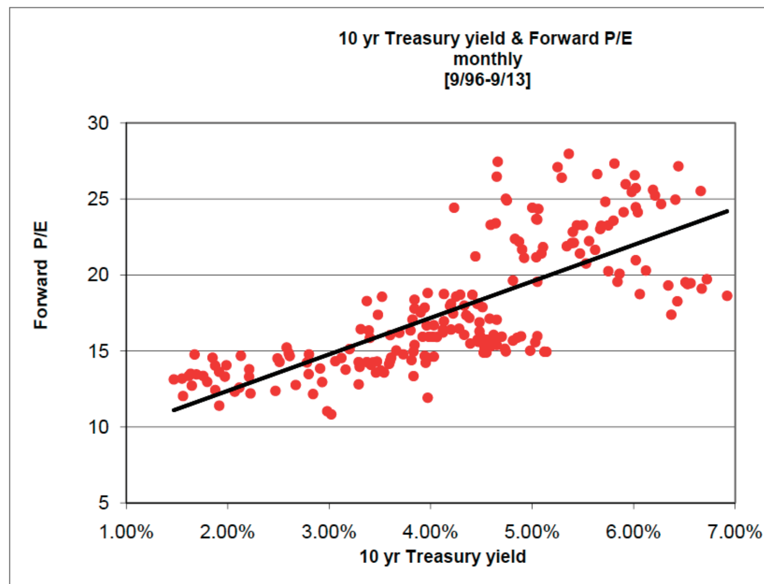
Thomas C. Stakem

The S&P 500 closed out the third quarter posting a 5¼% return for the quarter, 19.8% year-to-date and 19.3% for the last twelve months. Double-digit returns are becoming more frequent and may soon evoke memories of the back-to-back decades of 18% compounded annual returns (the 1980s & 1990s). Decade-to-date (the bull market commenced March 2009) the S&P 500 has returned 14% compounded annually. Stocks have banked ~20% this year while cash has earned pennies, bonds have lost up to 11% depending on maturity and emerging market equities lost 7.8%, made more respectable by only slightly lagging the S&P 500 with a 4.3% return in Q3.

A feature of the economic recovery over the last four and a half years has been the well below average pace of economic growth. 1.5% type real GDP growth is half or less of what used to be thought of as growth following recessions. Given the damage done to business and consumer confidence and net worth in the financial crash of 2008/2009 the ensuing recovery was bound to be slow, sluggish and uneven. Despite the headwind of feeble growth, corporate America has parlayed an environment of low wage inflation, low interest rates, and restrained capital spending into record profit margins and free cash flow, which in turn have funded higher dividends and share buybacks. Indications are that this can continue as wage and commodity cost pressures are manageable and interest rates are still so low that companies (even free cash generative ones) are warehousing cash via long term debt offerings. So for the moment the case for profit margin erosion is weak even in a low revenue growth environment.

What this augurs is a long, slow cycle. At times it may seem that the economy barely has a pulse and at other times it spurts to a 2% or better pace. But there is no reason the almost half-decade of 1.5% type real GDP growth cannot continue for the balance of the decade. This slow, curative scenario would enable confidence to build and long term investment planning be done by companies and investors. This is a prescription for mid-single digit EPS growth and P/E expansion for several more years. In five years this could

Continued on Page 3



produce $140 of S&P 500 earnings (a 6% compound annual growth rate), which capitalized at 16x-20x would yield an S&P 500 price range of 2,200 – 2,800. The lower end of the price range is all earnings growth driven while the upper end is half earnings and half P/E expansion. But it requires patience and a belief that a long economic cycle is a possibility. Investors are normally impatient for earnings growth. They want it now and they want it to be fast and at reasonable valuations. The long cycle thesis tests this thinking severely. Embrace it or be relegated to a few more years of negative "real" investment returns for cash and bonds.

My colleague, Bob Davidson, recently encouraged us to not fear the Federal Reserve's widely telegraphed tapering (reducing its bond purchases) program, fears of which sent Treasury yields up 1.25 percentage points. While this rise may be the bulk of the move for a few years another reason not to fear rising interest rates can be seen in the above plot of the 10 year Treasury yield and the forward P/E multiple of earnings for the S&P 500.

The latest coordinates (2.65%, 14.8x) can be seen to be just above the rising trend line. Higher P/Es and higher interest rates can co-exist – up to a point (4.5%-5.0%) it would appear. This observation is consistent with the belief that rising rates can be a healthy sign of a buoyant economy but can also at some point become unstable albeit at higher P/E levels. So another reason to not fear the taper – for the next 2 percentage point increase in 10 year Treasury yields - the market P/E should drift upward toward the 18x level.

With the Federal Reserve buying $85 billion worth of bonds per month as part its Quantitative Easing 3 (QE3) program, it's not a stretch to say that financial conditions are easy. Having been more preoccupied with building reserves and dealing with regulatory requirements, banks have been reluctant to lend over the past four years. Gradually, however, banks have increased their lending. Financing is clearly the grease which makes the cogs of the economy turn, and the improvement in lending conditions is an important harbinger of better economic conditions to come.

Existing senior loan officer data from the Federal Reserve reflects the easy, stimulative conditions of the past few years. Relative to early or mid 2009 the trend of the data has been in a steady, northeasterly direction as shown on the following page.

Market participants are currently mulling what impact the market increase in rates will have on the underlying economy. New home starts and home price growth have slowed somewhat. While the housing market may continue to slow, interest rates are still very low by historical standards. Normalizing interest rates is a healthy process and reflects the fact that economic growth is strong enough to withstand them. Even when the Fed starts to raise interest rates, it's quite possible that we would not see an economic impact on loan availability for another 12-24 months.

The U.S. has a lot going for it in terms of competitive advantages in the world today. A mobile work force with considerable slack, low interest rates

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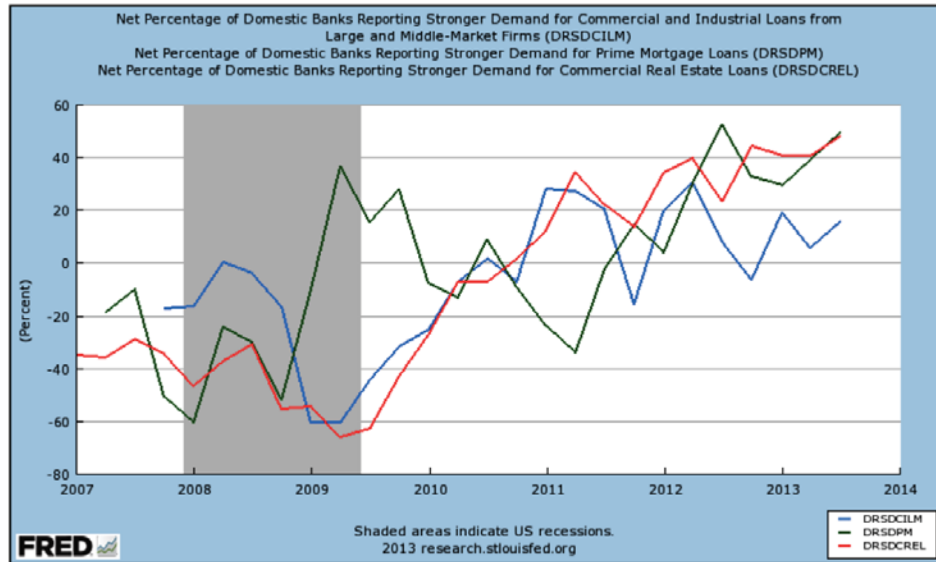

engineered by an aggressive Federal Reserve system, cooperative commodity cost factors (made possible by a slower growing and consumerist economy focused China and a strong dollar) and an energy supply revolution in the form of growing domestically produced crude oil & natural gas that has displaced foreign imports. In addition, looking out a little further the U.S. has a very favorable demographic profile thanks to an above average (and rising) fertility rate and migration inflows. Many of the countries we compete against are facing peaking/declining populations in the next four decades. Although these factors won't necessarily get priced into equity prices anytime soon they are positive trends which should affect capital flows and asset allocation decisions over time.

The factors that have gotten us here can generate even further appreciation potential over the balance of the decade. We are confident our diversified equity portfolios will perform well in this outlook. It's been a pleasant journey thus far in 2013 with stocks up 20%. And it encourages us to think that the destination a few years out will be even more rewarding. ◆

Thomas C. Stakem is a Portfolio Manager at Woodstock Corporation. You may contact him at tstakem@woodstockcorp.com.

Strataweb Update

David M. Layden

As you may know, Woodstock offers clients access to their accounts through an online application, StrataWeb. This feature provides instant account information, which is convenient, current, and simple to use and understand. Through online access, clients can view the following information for their account: account holdings, transactions, cash information, asset summaries, balance summaries, tax lot information, position detail, market values, pending trades, as of holdings, and past statements (within 16 months). Online access does not require any special software other than an internet browser. Safety and security features are built in to protect client data. If you'd like access to this feature, please contact your portfolio manager or portfolio administrator.

If you currently use Woodstock's online access, it is important to note that we have upgraded the security infrastructure surrounding StrataWeb. You should have received a letter and set of instructions to walk you through the process of updating your online account. Please note: all users are required to have an active email address tied to their account. This address will be used to communicate a one-time password to clients, necessary in the updating process. Email addresses were added during the initial account set up. If you don't think your email address is current you may either communicate the new address to Woodstock, or you can update online via directions that Woodstock provided with the previously mentioned letter. Please contact your portfolio manager, portfolio administrator or me, with any additional questions. ◆

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Tax Update

Jeanne M. FitzGerald

As mentioned in an earlier newsletter, the American Taxpayer Relief Act of 2012 (ATRA) revived the 39.6% tax rate. This new tax rate applies to taxable income over $450,000 for married taxpayers filing jointly and $400,000 for single filers. The ATRA also revived the personal exemption phase-out and the limitation on itemized deductions for higher income individuals. Individuals with adjusted gross income over $250,000 and married couples filing joint returns with adjusted gross income over $300,000 will be affected.

Starting in 2013, the maximum tax rate on qualified dividends increases from 15 percent to 20 percent. The 20 percent rate applies to the extent that a taxpayer's taxable income exceeds the thresholds set for the 39.6 percent rate ($400,000 for single taxpayers and $450,000 for married couples filing joint returns). The 15 percent tax rate still applies to all other taxpayers, unless they qualify for the zero percent rate available to taxpayers in the 15 percent or lower bracket.

Starting in 2013, higher-income taxpayers will be liable for a 3.8 percent net investment income tax. The definition of net investment income for surtax purposes includes interest, dividends, rents, royalties, annuities, net capital gains and income earned from passive activities. The tax is imposed on the lesser of the year's net investment income or the excess of your modified adjusted gross income over the threshold amount. The threshold amounts are $200,000 for single taxpayers and $250,000 for married couples filing a joint return.

An additional 0.9 percent Medicare tax applies to earned income above certain threshold amounts. The threshold amounts are $200,000 for single taxpayers and $250,000 for married couples filing a joint return.

ATRA also provides for a maximum federal unified estate and gift tax of 40 percent with a $5,250,000 exclusion for gifts and estates of decedents dying in 2013. Married couples can effectively protect $10.5 million from eventual estate and gift tax. The annual gift tax exclusion does not count toward the lifetime $5,250,000 exclusion. The first $14,000 of gifts made by a donor to each donee during the 2013 calendar year is excluded from the total amount of taxable gifts for that year. Gifts of present interest in property qualify for the annual exclusion. A present interest is any interest that is available for donee's immediate use, possession, or enjoyment. There is no limit on the number of individual donees to whom gifts can be made under this exclusion. Spouses can consent to "split" their gifts to each donee, effectively raising the per donee maximum exclusion to $28,000. Spouses may give an unlimited amount of gifts to one another. The annual gift tax exclusion is an easy and effective year-end tax strategy.◆

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