

W O O D S T O C K

QUARTERLY NEWSLETTER

Spring, 2014

From early 2012 we have calmed down. The generalized worry then prevalent has shrunk. This would seem to be at odds with a recession that keeps going, unemployed or underemployed recent graduates now suffering with 8 years of no growth government policies and governmental ideological hang-ups about tax rates, and an international situation disintegrating from post WWII peace to 19th and early 20th century aggression. However, the ineptitude of government seems to be reassuring to the private sector. Technology, raw creativity, healthcare innovation and amazing energy source discoveries are coming fast, successfully and without government control. This is heartening for supporters of free markets, freedom and democracy. Inappropriate government conduct and a desire to “lead from behind” means there is no opportunity to take credit for what they can’t do but could claim they are doing with a little chutzpah. With more of this type of government activity, the financial markets might keep rising.

While the stock market may benefit from this situation, industries which are not favored by the present administration, such as banking, mining and financial services are experiencing a regulatory onslaught. The SEC, our regulator, requires us to perform a written review of our policies and procedures annually, which we call our self-audit. We use this process to gauge how we fit into our industry. There are a great variety of products and businesses in our industry. We feel that we inhabit a very particular niche. The vast majority of funds we manage are invested in high quality US stocks. Our clients’ funds are held at a qualified sub custodian, an SEC defined term, and at that sub custodian the funds are held in our clients’ name, not in a pooled investment vehicle nor our name. Our accounting system allows comprehensive trust accounting, if needed, using a nationally recognized accounting software which we help to maintain through our sister company Woodstock Services Company, LLC. We are audited by a nationally recognized firm and carry appropriate liability and financial services insurance. Overall we feel very proud and confident in the investment product, security and service we provide you. While we applaud the regulatory effort to maintain high standards in our industry, the mere finding of fault in otherwise sound systems isn’t useful.

Using a trust for planning and future guidance and control purposes is a sound and successful strategy for multi-generational family wealth. Many people forget that it is the trust document that governs future decisions and the trustee is bound to faithfully execute the trust document. More people are realizing that with a well-constructed trust document, they have more flexibility than just picking a perpetual, experienced trustee, such as a bank, law firm or trustee office. The alternative involves family members or friends supported by a trustee cooperative office. As we did a year ago, we’ve asked Henry Phippen, the lead trustee of our sister company, Agawam Trust & Management, LLC to describe such a service. His article is part of this newsletter.

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.

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

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In This Issue:

Activists

Warming Up?

Agawam Trust

The Pied Pipers of Wall Street

Individual investors and investment firms usually have an investment DNA that reflects their investment style, approach, and the types of investments that intellectually and emotionally best suit them. Growth, value, large/mid/small, growth at a reasonable price (GARP) or just plain old opportunistic – wherever the bargains may be – are some of the major descriptors. Woodstock is a long term growth oriented firm.

One flavor or type of investor who has received a lot of notoriety in recent years is the “activist investor”. Decades ago they were called “green mailers” or “corporate raiders”. Many thought then (as now) that they were “hit and run” opportunists bent on capitalizing on the vulnerabilities of companies while feathering their investment performance or net worth.

An Internet search of the phrase “activist investor” is very revealing as to who the players are and who their targets of interest have been of late. In this newsletter we thought we’d explore several aspects of this golden age of activist investing phenomenon.

Who are some of the players?

William Ackman of Pershing Square Capital Management
David Einhorn of Greenlight Capital
Carl Icahn of Icahn Enterprises
Dan Loeb of Third Point
John Paulson of Paulson & Co
Nelson Peltz of Trian Partners
Paul Singer of Elliott Management

What motivates these managers?

- 2% and 20% business model – fees are 2% of assets and 20% of capital growth.
- Valuation mispricing either because of a poor performance record, a latent/hidden asset or improved return potential with better management focus, a change in capital structure mix or a discount to SOTP (sum of the parts) value.
- Very favorable reward/risk ratio; upside potential is manifold times the downside risk.

Sampling of companies drawing activist investor attention

In our search we encountered nearly four dozen companies who had earned the attention of activist investors in the recent past. Noteworthy to us was that 75% of these targets fell into four economic sectors. Consumer Discretion dominated (33%), Consumer Staples (17%) was next, Information Technology (14%) was third and Energy (11%) rounded out the leader board.

This suggests to us that activist investors prefer non capital intensive, relative quick inventory turn, low/no cyclical cash businesses and tend to avoid regulated, capital intensive (utility/telecom) and high intellectual property content (Health Care) businesses with patent protection. Energy may appear to be an exception but discount to net asset value was the key driver. Technology might also appear to be an exception to this but in Tech’s case the sector is a major hunting ground for activist investors because a reported 40% of the \$1.6 trillion in corporate balance sheet cash (the bulk offshore) is held by technology companies.

Additional thumbnail points on sampling of target companies:

Company / Rationale

- Apple** – returning cash to shareholders via dividends & share buybacks
Air Products – better execution leading to improved return on capital
Sotheby’s – weak margins, deteriorating competitive position vs. Christie’s
Chesapeake Energy – capital discipline and discount to net asset value
Dell – was taken private. Agenda/rationale to be determined.
EBAY – arbitrage valuation play - spin-off PayPal
Hess – deconsolidate – separate production from downstream operations
JC Penney – change CEO and turnaround operations and financial metrics
McGraw Hill – financial segment undervalued relative to comparable - Moody’s
Microsoft – return cash to shareholders via dividends & buybacks, CEO change
Murphy Oil – deconsolidate – separate production from downstream operations
PepsiCo – underperformed Coca-Cola – spin beverage segment off
Procter & Gamble – shrink to grow; divest/use proceeds to buy stock, raise dividends
Yahoo – arbitrage valuation play – embedded
Alibaba valued at a discount

How they operate?

Like hedge funds and private equity managers, activist investors receive a lot of attention by the financial press because their sound bites fill up air time and the activists cultivate the media to spread their message, to “talk their book” after establishing their positions. Many professional investors track the 13-D SEC filings of the top activist investors in the hope of gaining an insight into where successful investment ideas might

Continued on Page 3

come from. It is all part of “following the smart money”.

While not all hedge fund managers are activist investors all activist investors operate as hedge fund managers. The 2% & 20% economics enjoyed by hedge fund managers incents them to make things happen, to change perceptions about companies and to offer a road map to how higher short and long term valuations are possible.

Five identifiable phases

Accumulate – a position from 1% to 10% (in stock or options) typically

Agitate – for change in corporate structure, business or growth strategy, cash flow policy

Communicate – with company Board, Wall Street via mainstream and social media

Negotiate – with the Board over one or more of its recommendations for change

Vacate – sell position in the market or to the company and move on to the next target.

Background

Fully or over-priced markets see relatively little activism as there are fewer mispricings on which to capitalize. A high level of activist involvement at 1850 S&P 500 level is actually a favorable sign that value still exists in the stock market and that several companies possess exploitable value as evidenced by the activity level and number of companies “in play”. Some have speculated that General Electric’s portfolio pruning and finance spin-off is a sign that they too hear the footsteps of activist investors.

While the \$1.6 trillion of corporate balance sheet cash (even though most held offshore) is one of the main prizes/motivations of activist investors today there are several other factors at work. Even though stock prices have risen nicely it has been due to P/E ratio expansion more than corporate revenue growth in recent years. By and large revenue growth has been tepid (consistent with the most anemic economic recovery on record) in recent years. Profit margin gains and share count contraction have been the dominant drivers of EPS (earnings per share) performance the past few years. Activists no doubt read this trend as a need for many companies to shrink to begin to grow again. From a value oriented activist investor’s standpoint there are scores of companies that have been poorly managed over the last five years and their stocks could benefit from a business segment divestiture, an entire company outright sale or merger and/or a change in management.

Activist investors have a keen sense of absolute and relative value of companies in specific sectors and industries. This can lead to identifying mispricings because a company’s problems are misunderstood or their strategy has not been effectively articulated by management. One notable feature of the list of targeted companies currently in the gun sights of activists is their market capitalization. The trend is toward larger market cap sizes in contrast to 20-30 years ago when the green mail operators and corporate raiders were focused on smaller companies. But this looks entirely rational as the two worst performing Morningstar investment styles in 2013 were large cap value (+25%) and large cap growth (+30%). By comparison small cap growth (+41%) and mid-cap value (+39%) were the top two performing investment styles. In 2012 large cap value was also the worst performing of the nine Morningstar styles. And since March 2009 the three large cap styles (growth/value/core) have been the three worst performing styles. As Willie Sutton remarked about why he robbed banks, that’s where the money is, so too activist investors could point to the large cap (particularly value) style niche as the most productive pond in which to be fishing for target ideas.

What drives activists to pounce on their prey?

They are agents of change. To force the investment community to look at a company differently, in a more valuable light, based on the changes they propose is the catalyst for a successful investment. Activists are investment agnostics. They don’t worship at a particular investment style altar like most long only investment managers. Activists will go where they perceive the money making opportunities exist. Their edge is in triggering changes in the baseline view of the company and/or its valuation. Activists believe implementing their proposals would increase growth, returns on capital and free cash flow all of which would benefit shareholders.

Activist managers rely on extensive due diligence before accumulating investment positions (usually 1% to 10%) in their target companies. Managing concentrated, undiversified portfolios as they do – one to two dozen positions typically – compels one to be very thorough and sure of fundamental and valuation assessments.

Short-term vs. Long-term & the wrong incentives

It is true that the 2%/20% “business model” of hedge funds incents activists to go for short term value maximization tactics rather than creating long term shareholder value. That is a financial reality. Although there are short-term investors

Continued on Page 4

who anticipate (and even follow) activist investors in buying into their target companies and who are unconcerned with the long term, classic financial theory would inform that this influence was quite short-term in duration. Believing that activists can inflate stock prices to the detriment of long term fundamentals defies the notion that today's share price is the present value of all that is known about a company's future prospects. If its future were irreparably harmed the stock, would suffer not gain. Thus, positive "news flow" created by an activist investor announcement would have a transitory influence on share price unless the perceived future for that company was enhanced by the activist's proposed changes.

In addition, the activist doesn't know what it is like to be a "passive" investor like most individual investors and even some institutional investors with low annual portfolio turnover. The activist investor manager can "make news" any day of the week, announce they have accumulated/increased an equity position (or if over 5% they will have to file with the SEC) and plan to commence discussions with the Board of Directors on how to increase the value of the company. Normally their reasoning and proposals are publicized and may include replacing the CEO, divesting a division or business segment and demanding a higher share of cash flow be dedicated to share buybacks or increased dividend payouts. And there is always the threat that a proxy fight will be launched if the activist's recommendations are either dispatched or only given token attention by the incumbent management, which has produced the uninspiring record.

Activist investors are simply not content to entrust their investments to management to execute a strategy over a period of years and be rewarded by long term capital appreciation. (That's what individual investors do). Rather they see themselves as the agents of change who will propose the value creating steps management needs to take. As they see it the value accretion process is much quicker with their urging and the time value of their investment is maximized. Current estimates are that \$85 billion (presumably unlevered) is pursuing activist strategies. If the performance returns follow then this amount will grow.

Conclusion

Monetary conditions are favorable for deal-making and the stock market value counter has a lot of large cap merchandise on it at the present time. Recent year investment style performance as well as activist investors are telling us that. While many believe that the activists are a nemesis to long term investing because they are only interested in short term gains, that may be a misnomer. The average activist hedge fund holding period according to one recent study is 20 months which implies 60% annual portfolio turnover. That rate is less than the mutual fund industry's often cited 100% turnover rate which equates to a 12 month holding period. Although Woodstock doesn't chase activist investors, our clients have benefitted from activist involvement in some of the companies in which we invest. ♦

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Warming Up?

Adrian G. Davies

A strong US economy is good for many things, but at least in the near term, it could be a negative for the markets. We would not advise selling stocks into a strong economy, because it's likely that the market will ultimately reflect the economy's underlying strength, resuming its upward trend. However, there are several dynamics related to strong economic growth which could hold stock prices back in the short term.

Many economists are forecasting an uptick in business investment spending, something that has been relatively lacking in this current economic upswing. If business leaders were truly optimistic about the economic outlook for the US, they would be investing more.

It seems likely that they will. Factory capacity utilization rates have recovered to 79.2%, orders from Institute of Supply Management (ISM) surveys

have remained strong, and bank lending to companies has increased. However, strong profits have been one of the core underpinnings of the stock market rally over the past five years. Companies have been able to drive profit margins to record levels by limiting spending, including investments. If corporate America were to go through an investment cycle, it would be good for companies' long term profit outlook, but new investments might dilute profit margins in the near term. First quarter GDP in the US seems to have been suppressed by extreme weather conditions. If so, we should see a snapback in the second quarter. In the absence of dilutive investments, sales and therefore profits are expected to snap back as well.

We have discussed in previous Quarterly Market Perspectives how stronger economic growth is

Continued on Page 5

likely to lead to higher interest rates. As people see stronger economic forecasts, the demand to borrow money increases, while investors seek more aggressive returns in stocks rather than bonds. These factors tend to drive interest rates up, with or without inflation. Higher interest rates would lead to higher interest expense, crimping profitability of companies with higher debt levels.

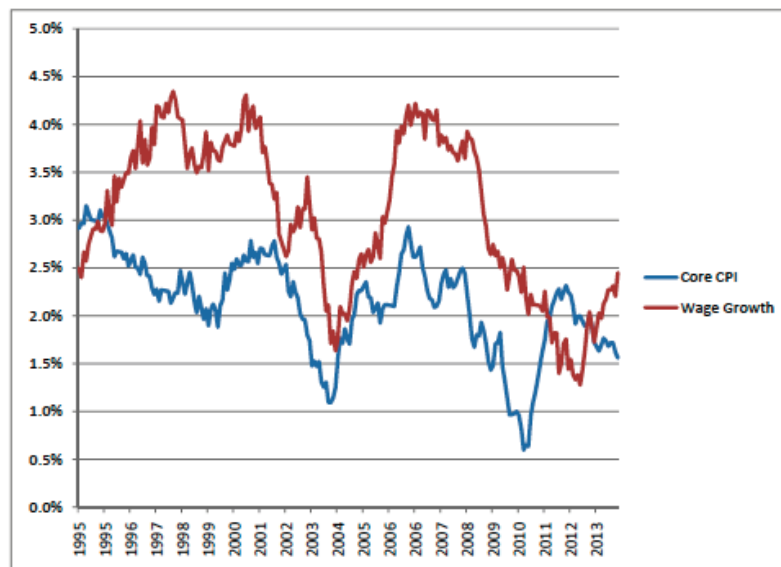
The threat of deflation remains a dominant concern for many economists. The Federal Reserve continues to have extremely easy monetary policy precisely because Fed governors are concerned about the impact that outright deflation – falling prices – would have on economic growth. However, it is certainly possible that deflation is no longer the most significant risk facing the US economy. Those fearing deflation would be greatly relieved if this were true.

Although most measures of inflation remain subdued, wage growth is creeping up at a 2.2% to 2.5% y/y rate (average hourly earnings of production and nonsupervisory employees). That is certainly not roaring, but it is ahead of the Consumer Price Index, and ahead of where wage growth has been over the past few years. It is good for anyone receiving a paycheck, but wage growth is one of the more important factors the Federal Reserve weighs when considering the outlook for inflation. The current unemployment rate of 6.7% is towards the middle of its historic range. Before retracting its numeric target for unemployment, the Federal Reserve had suggested that it would start raising interest rates when the unemployment rate got below 6.5%.

Economists are actively debating whether or not wage increases are a result of limitations on the supply of labor. While the unemployment rate has dropped considerably from its 10.0% peak in 2009, many argue that workers are not sufficiently benefitting from the recovery, and too many remain out of work. Of the 10.5 million individuals that are looking for work currently, 3.7 million have been out of work for more than six months. They are considered the long term unemployed. The workforce participation rate is another statistic demonstrating this concern. It measures the number of employed and those actively looking for work as a percentage of the total population that could be working. At 63.2%, workforce participation remains low. There are at least two factors driving the low participation rate: first, people are so discouraged looking for work that they have stopped looking; and secondly, approximately 300,000 baby boomers are choosing to retire each month. Will either of these groups re-enter the workforce if economic prospects improve, and if they do, will they re-enter in big enough numbers to keep wage inflation from rising?

A recent study from Princeton University suggests that they will not keep wage inflation from rising. Specifically, this study, “Are the Long Term Unemployed on the Margins of the Labor Market?” by Alan B. Krueger, Judd Cramer, and David Cho, found that the level of short term unemployment is a better predictor of wage growth and inflation than the total level of unemployment. This study suggests that even with 6.7% unemployment, the US economy could start to see stronger wage growth (yes, good), but also inflation.

Continued on Page 6



Source: St. Louis Federal Reserve

Agawam Trust
Henry P. Phippen

Pressures on profit margins could therefore come from investment spending, interest expense, or wage growth. There are positive implications of these economic forces for those looking for work, and those seeking higher wages. However, they could be bad news for investors, at least in the near term if lower profit margins pressure stock prices. Greater confidence in the economic outlook could mean higher price-to-earnings ratios,

Over the past year, we have received inquiries about how a family can benefit from their family trusts without being forever tied to a bank trust department, law office, or trust office. We have asked our related company, Agawam Trust and Management, LLC (“Agawam”) to discuss more about its business, as was earlier featured in the Spring, 2013 issue of the Woodstock Quarterly Newsletter.

Agawam Trust and Management, LLC (“Agawam”) serves as a family trust office for two three-generation families, and two related two-generation families. For these family groups, Agawam principals assume the role and fiduciary responsibilities of a lead trustee. Agawam also offers similar services to other unrelated families as trustee consultants. In this consultancy structure, these families are able to provide their own trustees who make the decisions but have Agawam principals available for advice and guidance and to deliver the fiduciary support services necessary for this demanding family job.

Agawam is a fifth generation family office operated as a family trustee cooperative. Each of the trusts managed by Agawam has multiple trustees, where the outside trustees delegate the authority to manage the day-to-day activities of the trust to their Agawam co-trustees. 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 each trust as written and its beneficiaries. The Agawam trustee acts as the point person for the trust.

Other family groups can and do benefit from Agawam’s knowledge and experience owing to our families’ five generations of trust and wealth management successes. We have shared and continue to share this knowledge with others who have asked us to assist their families. Confidentiality, objectivity, and impartiality to its clients are by-products of Agawam principals’ own involvement as grantors, trustees and beneficiaries.

potentially offsetting any margin pressure on stock prices, and all forecasts should be taken with a grain of salt. In so far as forecasts for more capital expenditure, higher interest expense, and higher wages prove wrong, the implications could be positive for the market. Ultimately, a modest growth environment should be favorable for stocks. ♦

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Agawam’s family cooperative has a history of successful intergenerational management of family trust networks, handling stressful as well as inspirational times. Our approach to planning is not targeted solely on wealth transfer and how and where the money is moved, but also on the nurturing of human capital. It is often the hope of the grantor of a trust that the focus is not on money alone. When a family engages in the meaningful conversations that capture their history they are far more likely to successfully manage the generational transfer of the family’s assets and legacy. Succeeding generations will be informed of what was and what remains important.

For clients who are concerned with “who will take care of things when I die”, Agawam principals, 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, and most likely emotionally-charged, undertaking that ought to be handled in an efficient, objective and competent manner.

Agawam provides a high level of service in an individually customized, client-focused manner. We benefit from over 80 years of family trust experience and help plan for the emotional content of family trust assets. We continue to share our knowledge with the next generations and with others. We offer similar fiduciary services to unrelated clients as consultants to other existing or potential family trustees who do not have the time, expertise, or store of knowledge that is required.

Please contact me directly or through your investment manager if you have any questions or comments. ♦

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