

# W O O D S T O C K

## QUARTERLY NEWSLETTER

Summer, 2012

In looking back over the last six months, we are surprised at how long a bad financial situation can hang on. It's not that we didn't anticipate this stagnant time both nationally and internationally, we did. It's the surprise that available solutions have not been used. Whether democrats or republicans, whether President John F. Kennedy or President Ronald Reagan, cutting taxes in a recession is accepted as sound policy that works, but not now.

From the gloom of present day news stories and financial statistics, however, there are strong rays of hope. We recently attended a key note speech by Robert Reynolds, president and CEO of Putnam Investments, who reminded his audience of the bright future he sees for the US and the US stock market. If we survive the present short-term difficulties by avoiding being frozen in place by our political processes, we'll be able to unlock our potential and win our share of a worldwide race to solvency. The US advantages run from founding principles to our fairly quick recovery from 2008 something other nations have yet to do, to demographic, energy, domestic manufacturing, farm productivity and new technology advantages. For the stock market, where did he predict the S&P 500 to be in 2020? 6500.

How do we position Woodstock and its clients' portfolios to take advantage of that over the next eight years? We invest in the human intellectual talent to pick good companies for our clients' portfolios (our investment managers). We invest in the research to be sure that new good companies are ready to move into portfolios as some of our past successes mature (our new Strategies effort). And we invest in the support systems to keep our costs low (Woodstock Services Company).

If we think Mr. Reynolds may be a bit too optimistic, and that the majority of the US voting population has moved from a strong tradition of limited government and individual responsibility to something else, we would make the same moves to get Woodstock and its clients ready. Investing in high quality companies was the best protection during the turbulent times from 2008 on.

If we have the best investment method to take advantage of what may happen in either direction, why does our philosophy seem to be such a small voice in such a noisy investment world? Charles D. Ellis, former chair of Yale University's investment committee recently wrote an article now circulating through the institutional investment world describing why institutional investors persistently fail to achieve their investment goal of superior results or "beat the market performance". He reviews the goals, business practices and foibles of investment managers, investment consultants, fund executives for institutions and the institutions' investment committees. He describes five reasons for the underperformance: high fees, the costs of manager switching, hiring managers late, firing managers late, and investing with managers and in asset classes that underperform. While each group comes in for its share of blame, we were interested in his critique of investment managers. Many of his points echo Laury Foster's article last quarter on the ascendancy of the sales culture at investment management firms. From the presentation of results with the "illusion of validity" to selected time periods producing "enhanced results" to the fact that costs do matter to the often said "past performance does not predict future performance", the list was not flattering. What should happen? Talking candidly with clients about how difficult investment management has become and developing a realistic shared understanding of how difficult achieving superior investment results is were the solutions. The opportunity to buy low and sell high requires that understanding. We do believe that what we offer our clients at Woodstock is the best that the investment world offers its clients.

We also 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. ♦

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*Paul D. Simpson, President*  
*William H. Darling, Chairman*

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## Beyond Investment Management

M. Elena Gillespie

It is no secret that over the past few years the investment industry has faced tough scrutiny from the SEC in an increased effort to safeguard investors' assets. At Woodstock, we take our fiduciary responsibilities and compliance with current industry regulations very seriously. We strive for transparency in all of our dealings with clients.

Working with our experienced portfolio managers, our clients are likely familiar with many of the advantages of individually managed accounts. With an individually managed account, securities are owned by the client and not a fund, and security buy/sell decisions are made specifically on the client's behalf based on their individual investment objectives, rather than on behalf of all shareholders in a fund. Having the ability to buy and sell securities directly on a client's behalf also helps significantly in tax planning such as harvesting capital gains and losses to manage tax liability. Investment related expenses incurred by the clients are only those related to their investments not the expenses of a fund.

Many of our clients choose to take advantage of our arrangement with SEI Private Trust Company, "SEI", as a qualified sub-custodian. Through this arrangement, we provide custody services for individually managed accounts at no additional cost to our clients. Our relationship with SEI offers several benefits. While SEI serves as custodian, we work closely with SEI in monitoring client account activity. In addition working with SEI, Woodstock can assist clients with cash distributions, bill payment, tax payments, and any philanthropic programs. SEI also provides accounting options often not available through other custodians. Clients receive an account statement at least quarterly, which is mailed directly from SEI detailing all recent account activity. Clients also may elect to view their account information online. Investments custodied with SEI are also subject to a surprise examination by an independent auditing firm, currently Pricewaterhousecoopers.

We also offer proxy voting services through an independent third party proxy service, Broadridge, for those clients wanting this service. Proxies are voted by Broadridge in accordance with proxy voting guidelines with the intent of serving the best interest of Woodstock's clients. Proxies are voted according to pre-established voting guidelines that address specific topics. Copies of these guidelines are available upon request. Issues outside of such guidelines are considered on a case-by-case basis.

In addition, our highly experienced staff at Woodstock Services Company, LLC, "Woodstock Services," is available for tax preparation and accounting services at an additional fee. Many of our clients take advantage of these services where our tax preparers can work closely with portfolio managers to develop and execute a tailored tax strategy. Our tax preparers are experienced in complex tax areas impacting affluent investors as well as the preparation of individual and fiduciary returns. Woodstock Services also offers an array of accounting and tax services for those clients who are involved in their own businesses. We are also experienced in the preparation of corporate and partnership returns. We invite you to arrange a time with our professional staff to discuss any tax or accounting issues that may be a concern.

We are also proud to announce the launch of an updated Woodstock website. Our website details the experience of Woodstock's professionals and the services we offer as well as the advantages of joining Woodstock. Please visit us at [www.woodstockcorp.com](http://www.woodstockcorp.com).

We welcome your comments and suggestions including topics for future newsletter articles. Please feel free to contact me directly for more information or with any questions. ♦

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Performance Highlights

The stock market for the 1st half of 2012 has been struggling with Europe, concerns over a U.S. economic slowdown that began early in Q2 after months of uninspiring employment growth reports, worries over China's 7%-8% growth rate dropping perhaps in half, the "fiscal cliff" ahead in the U.S. in 2013 and the U.S. election outcome. Without these concerns it is unlikely we'd have multi-decade low 10 and 30 year interest rates and softening energy prices. Classic economic logic would suggest this combination should reinvigorate economic activity at some point but near term EPS estimates and investor confidence (P/E's) may continue to face headwinds.

Only a strong +8% June rally saved the month (and quarter) from being a double-digit loser, limiting the S&P 500 damage to 3% for the quarter. This yielded an 8% price gain for the first half of 2012. With all that investors face in 2H 2012 annualizing the 1H performance would be readily accepted. Looking at the S&P ten economic sectors the strongest performance belongs to defensive stock groups in Q2.

<u>S&amp;P Sector</u>	<u>Q2 % chg</u>	<u>YTD % chg</u>	<u>current yield</u>
Telecom	13%	13%	4.7%
Utilities	5%	3%	3.9%
Cons Staples	2%	7%	2.8%
Health Care	1%	10%	2.2%
Cons Discretion	-3%	12%	1.5%
Industrial	-4%	6%	2.5%
Materials	-5%	5%	2.3%
Energy	-7%	-3%	2.1%
Financial	-7%	13%	1.8%
Info Technology	-7%	13%	1.1%
S&P 500	-3%	8%	2.1%

The yield curve flattened considerably during Q2 as short rates (out to one year) rose while 10 and 30 year yields fell 50-60 basis points. Except for the grain (wheat, corn) markets commodities had a rough quarter as concerns over China slowing and a strong dollar (+3%) hurt sentiment toward cyclical/growth themes. The energy commodities continued to have a split personality with crude oil down 18% while natural gas rose 41% (from a very depressed base). strongest performance belongs to defensive stock groups in Q2. The most defensive stock sectors were the most offensive

performers as evidenced by Telecom, Utilities, Consumer Staples and Health Care. Three of the four BRIC (Brazil, Russia, India, China) countries - except for China - had a particularly rough Q2 declining 18% to 42%. The Brazilian real and Indian rupee were each off 9% during the quarter and contributed to the rough treatment of stocks.

Around the Globe

With the election of Francois Hollande as President of France and the recent Greek vote to stay in the Euro zone, the outlook for heavy doses of austerity continuing to be at the top of policy-makers options has no doubt peaked and is declining. Politicians don't like losing elections, particularly for reasons of not spending enough. So they've received the message and will rely less on spending cuts and either more on tax increases or other imaginative ways to borrow more money. Hollande's first three actions were (not necessarily in exact order): significantly lowered executive compensation for companies that the state has substantial ownership in, raised the tax rate on upper income earners to 75%, and lowered the retirement age to 60. This policy mix is not likely to nurture economic growth, investment, or entrepreneurship. Any serious interest in controlling spending will be taken up later in the President's five year term.

Greece presented to international debt inspectors in early July "alarming" data on its experience with austerity policies and it will show how devastating the exercise has been. Overall unemployment exceeds 22% (2x Euro zone average) while youth (15-25 yr olds) unemployment is 55% as GDP has contracted 20% over the last five years. Spain has an almost identical unemployment picture. While the debt-to-GDP ratios of these countries clearly indicate they've lived beyond their means for years, a better set of policies must be found if growth, the seemingly forgotten component, is to return in any meaningful way to the global economy. Debt rescheduling (lengthening maturities) at reduced rates and write-offs have to be centerpieces of the eventual solution but this process is likely to take another five years. Capital markets want quick, clean and decisive solutions to crises (company or governmental) but in this instance more time is a certainty. Axel Webber, Chairman of UBS AG and former

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President of the Bundesbank, recently commented on the difficult task that government officials and central bankers were now confronting over saving the European Union (EU) and said "What makes these things so difficult now is we're trying to construct insurance after the accident has happened". He went on to say that the blueprint being developed now would be implemented with parliamentary debates that would take years to accomplish.

China's PMI (purchasing managers index) declined in both May and June. This suggests a sharp slowdown may be in the offing in 2H 2012. China will likely resort to tax cuts, monetary stimulus and infrastructure spending to stimulate growth. Recent interest rate and reserve requirement ratio reductions confirm this. With headwinds to their export sector still strengthening as developed economies slow down there is a real risk that China could be pushing on a string. And China is the globe's leading and most dependable growth driver! Data integrity is also an issue as observers suggest local and provincial officials are inflating the strength of data they report to the government statisticians that produce the country's key indicators. The lack of volatility in China's reported growth rates has long been a curiosity and source of skepticism in the west. A herculean effort can be expected by China to sustain 7%-8% growth.

#### U.S.

U.S. factory output fell for the first time in 3 years in June. This signals a decline in overseas demand for U.S. products which is quite understandable. Along with the last few sluggish employment reports the immediate jobs outlook is guarded at best given a decelerating economic backdrop. This is confirmed by the mid-year American Chemistry Council activity barometer which is signaling a drop in industrial output and a risk of the economy slipping into recession. The latest (June) reading shows the biggest gap vis-à-vis Industrial Production since March 2009 when the economy was mired in the deepest recession since the Great Depression. Falling chemical demand typically precedes lower Industrial output and broader economic slowdowns by about three to eight months. Slowing and sub-par growth is in store over the next six to nine months if this indicator is accurate.

The U.S. economy is vulnerable to some fiscal drag in early 2013 particularly as 2H 2012 now looks devoid of any momentum. Risks are tilted to the downside - Europe and self-inflicted fiscal tightening. And the debt limit ceiling issue coming up early in 2013 won't facilitate harmony in Congress. Business and consumer confidence appears likely to soften in 2H 2012 against the prospect of sub 2% real GDP growth. The clouds over 2013 would likely keep business hiring plans on the back burner so no improvement in monthly employment (100k) and the 8% + unemployment rate is likely. More significant for economic activity is the likelihood that consumer confidence among the 92% employed will likely remain cautious as the economy remains stalled out and as the reality of several new taxes kick in next year now that the Affordable Care Act has been found constitutional. In addition, the tax on dividends will rise steeply to a top rate of ~40% (from 15%) and the long-term capital gains rate will increase to 20% (from 15%).

#### Goodbye to 2% real GDP growth

The "muddle through" case is slowly becoming the optimistic case. Two percent real GDP growth has been trend growth since Q1 2007, several quarters before the recession began. Unless one maintains optimism about a "lame duck" Congress passing compromise legislation, a \$500 billion fiscal cliff could hit the economy in Jan 2013. This would likely result in the U.S. economy not experiencing 2% real GDP growth for seven quarters or until Q4 2013. With the next few quarters' growth tapering off from Q1's 1.9% there is not a lot of room for policy errors at this point in the cycle. The S&P 500 may currently be reflecting a slowdown or double-dip in 2H 2012 but it is not discounting the financial consequences of seven more quarters of below 2% growth. Not only are investors assuming the "fiscal cliff" does not occur but Chairman Bernanke, the Federal Reserve and the IMF (expects U.S. to grow 2% real GDP in 2012 and 2.25% in 2013) are assuming that outcome as well. While logic may be their best ally, some Congressmen are already concluding that they may be better off doing nothing and revisit the issue when the new (113th) Congress convenes on January 3, 2013. A repeat of Q1 2011's 0.4% real GDP or worse could easily occur.

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Because the consequences of inaction are so dire Congress is likely to pass legislation that delays the tax increases and spending cuts into 2013. While it is difficult to argue that a 1365 level on the S&P 500 has priced in a lot for this outcome it should still be a relief to the market.

Longer term it is the U.S.

There is a great deal to like about the U.S. economy – absolute and relative to other major countries – from a currency, energy supply, labor supply, and political security standpoint. These competitive advantages are setting the stage for a multi-year bull market in stocks when everything falls into place. Good, visible economic growth will be good for EPS and P/E expansion will occur as capital markets reward financial leadership and execution. Patience for this bullish outlook to take hold is more tolerable when interest rates are low and dividend yields are high.

Bullish potential

So Europe is in recession, India's economic growth is starved for available energy inputs, China's growth rate and economic statistics are being questioned and the U.S. growth will almost certainly be less than 2% into year-end and then it faces real growth challenges in 2013 because of sequestration spending cuts and several forms of higher taxation. This suggests a coordinated (U.S., Europe, China) monetary policy that will produce lower interest rates and perhaps stunning additional quantities of liquidity before all is said and done. Given recent year economic history and the real-time data being reported there can be very few policy makers who are worried about inflation. Most believe that fighting inflation is secondary to nurturing growth now and for the next few years. All this is favorable for stocks.

If the stock market rises, defensive stocks won't be the leaders. Yield oriented investors have bid Telecom and Utility sector valuations up to relative P/E premiums of 60% and 20%, respectively. The safety and comfort of above average yields and regulated rates of return will quickly dissipate once attention can shift to growth when less yield and more robust EPS growth prospects will garner the attention. While that inflection point doesn't

S&P Sector	forward P/E	Q2 % chg	YTD % chg
Cons Discretion	15x	-3%	12%
Cons Staples	16x	2%	7%
Energy	11x	-7%	-3%
Financial	11x	-7%	13%
Health Care	13x	1%	10%
Industrial	13x	-4%	6%
Info Technology	12x	-7%	13%
Materials	13x	-5%	5%
Telecom	20x	13%	13%
Utilities	15x	5%	3%
S&P 500	13x	-3%	8%

appear to be anytime soon, the stock market has the potential to discount developments very far ahead.

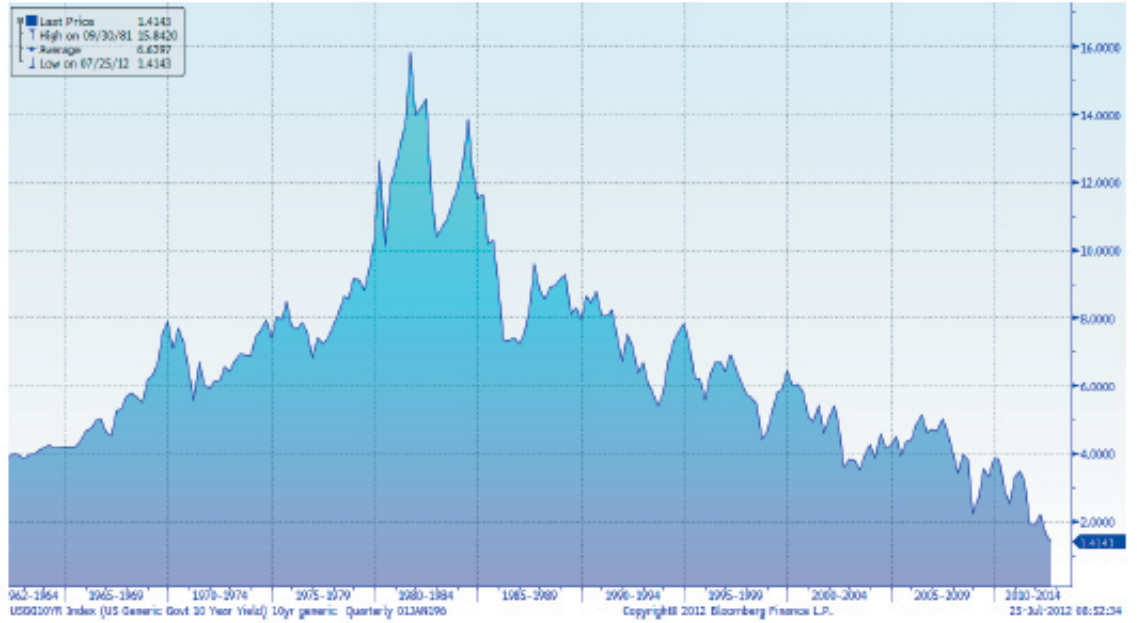
Two long term plots of 10 yr & 30 yr Treasury yields – with 60% of the S&P 500 yielding more than the ten year Treasury yield (and 50% of the index' constituents yield more than the S&P 500) the Federal Reserve's desire to move investors out on the risk curve may just be positioning them for the onset of a secular bull market. With low yields on cash and bonds, stocks are the only asset class for both wealth building and income generation (see bond yield plots).

Transitioning from cyclical to secular bullish

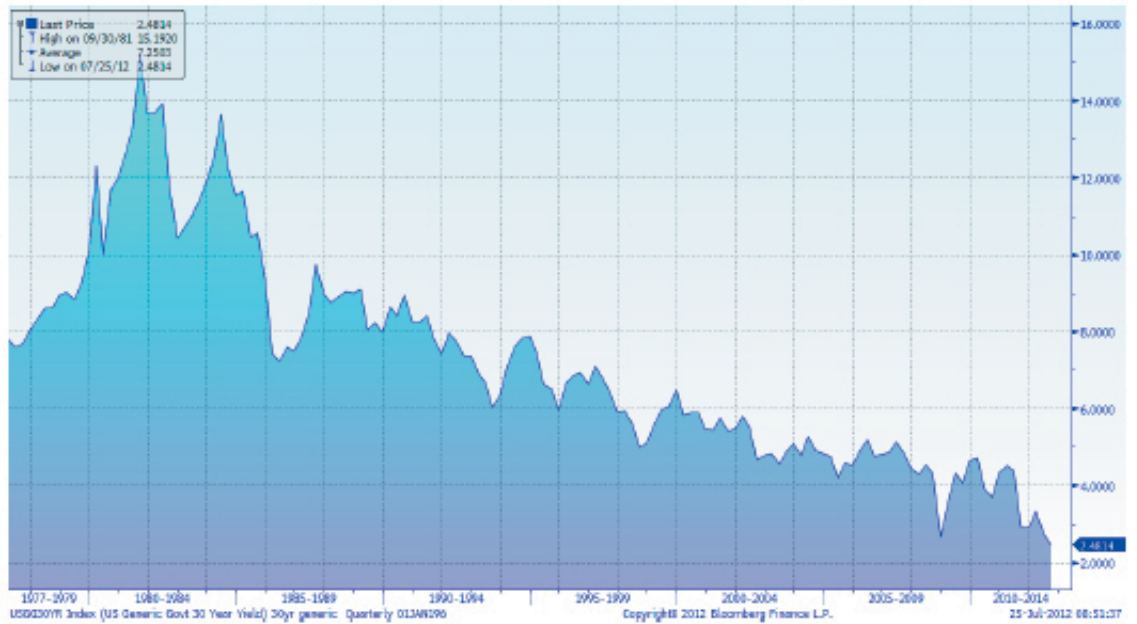
With each passing day the U.S. looks like a better and better place to invest than other major markets. Perceptions that the U.S. possesses a strong economy and a strong currency should be favorable for global asset allocation flows. Certainly among developed economies the U.S. is favorably positioned relative to Europe which could be facing a lost decade depending on policy decisions there. Emerging market economies and their currencies have faltered and could still be attractive investment alternatives but the U.S. looks to be king for a while. Renewed dollar weakness would only occur should the financial crisis in Europe be addressed in a convincing and decisive way. It is hard to see how that could be at all possible at this stage. One has the feeling that the European Union – the financial union, the fiscal union, its politics and the Euro currency issue will be headlines for the next several years. The U.S. will continue to be a beneficiary of this trend. ♦

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### 10 yr US Treasury



### 30 yr US Treasury



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The tax provisions enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) are referred to as the "Bush-era" tax cuts. The 2010 Tax Relief Act extended the tax provisions of the EGTRRA and JGTRRA through 2012. The provisions of the Bush-era tax cuts are now scheduled to expire at the end of the year.

Lower marginal individual income tax rates, marriage penalty relief, lower capital gains and dividends rates, and the increased child tax credit are among the provisions to sunset, or revert to the provisions in effect before the Bush-era tax cuts.

The current individual marginal income tax rates are 10, 15, 25, 28, 33 and 35 percent. Absent any action in Washington, the prior law tax rate brackets of 15, 28, 36 and 39.6 percent will be effective for tax years beginning in 2013.

Qualified capital gains and dividends are currently taxed at a maximum of 15 percent. Taxpayers in the 10 and 15% tax brackets pay 0% on qualified capital gains. The reduced tax rates are scheduled to expire on December 31. The maximum rate on net capital gains is scheduled to rise to 20% in 2013 (10 % for taxpayers in the 15 percent tax bracket). Unless Congress acts, qualified dividends will be taxed as ordinary income after 2012.

The limitation on itemized deductions is scheduled to be reinstated after December 31, 2012. Higher-income taxpayer's allowable itemized deductions are reduced by three percent of the amount by which their adjusted gross income exceeds the threshold. The phase-out rule could eliminate up to 80% of higher-income taxpayer's itemized deductions for mortgage interest, state and local taxes, and charitable contributions. Medical expenses, investment interest, theft and casualty losses, and wagering losses are excluded.

The personal exemption phase-out will be revived for certain high-income taxpayers for tax years beginning in 2013. The deduction for personal and dependency exemptions may be reduced or even eliminated for taxpayers with adjusted gross income in excess of certain thresholds.

The so-called marriage penalty relief is scheduled to sunset as well. The basic standard deduction for married couples filing a joint return will no longer be double the basic standard deduction for unmarried individuals filing a single return.

A child tax credit for each qualifying child under the age of 17 is available to taxpayers with income below certain threshold amounts. The \$1,000 child tax credit is set to revert to \$500 per qualifying child in 2013.

A dependent care credit allows working taxpayers a credit for a percentage of child care expenses for children under the age of 13 and disabled dependents. The monetary amounts of the child and dependent care credit are scheduled to be reduced to levels prior to EGTRRA. The maximum amount of qualifying expenses will be reduced to \$2,400 from \$3,000 for one qualifying child and to \$4,800 from \$6,000 for two or more qualifying children.

The American Opportunity Tax Credit is one of the education-related tax incentives set to expire on December 31, 2012. The credit is the sum of 100 percent of the first \$2,000 of qualified tuition expenses and 25 percent of the next \$2,000 of qualified tuition expenses. It phases out for taxpayers with modified adjusted gross income between \$80,000 and \$90,000 (\$160,000 and \$180,000 for married taxpayers filing joint returns). The Hope Scholarship Credit with its lower benefits will return in 2013.

The current estate tax rate is 35 percent with an applicable lifetime exclusion amount of \$5,120,000. The gift tax is reunified with the estate tax for gifts made after December 31, 2010. Both the estate and gift tax rates are scheduled to sunset on December 31, 2012. After that date the unified estate and gift tax exemption amounts return to \$1 million with a maximum tax rate of 55 percent.

The tax increases related to the Affordable Care Act (3.8% on net investment income plus 0.9% Medicare tax on wages and self-employment income) are effective for tax years beginning after December 31, 2012. These tax increases are in addition to any increases in dividends, capital gains and ordinary income rates associated with the expiration of the Bush-era tax cuts. We will address the Affordable Care Act in more detail in the fall newsletter. ♦