WOODSTOCK

QUARTERLY NEWSLETTER

Fall, 2012

In This Issue:

Don't Just Stand There - Ease!

It's October 2012, Do You Know What Your Estate Plan Says?

Tax Update

We're starting to get some comments back on our Quarterly Newsletter articles and, as Elena Gillespie mentioned last quarter, please let us know your comments and ideas for future topics. The commenter we'll refer to said: "please talk about asset allocation, you're spending a lot of time talking solely about equities." OK, however, we like equities, as will be evident, but let's start with asset allocation. Why is asset allocation important? Our objective is to realize a return on assets invested. We need to hedge against disaster. We need to understand the risks involved with investing in different asset classes and we need to reduce risk through diversification. These four points are boiled down to the investment objectives that govern how your account is managed at Woodstock. The asset allocation decision is the way those four points are combined to create an investment portfolio.

We recently reviewed an article, written for institutional investors, summarizing views on asset allocation published in January 2011. Why so old? Asset allocation principles don't get old. Vehicles for investment get tweaked, investment theories come under stress and the new hottest idea is always right in front of us whether in new media or old, but the four principles listed above don't change. In this article what ideas did we like? We liked three of the eleven summary ideas. First, watch your liquidity. Be prepared for the possibility that unexpectedly either inflation or deflation could hit. Second, review your portfolio. Capital market returns tend to be concentrated in bursts with long periods of sideways movement and relatively short periods of decline and appreciation, so position the portfolio to take advantage of buying low and selling high. Finally, maintain a quality bias. Quality equities have proved to be defensive in the recent past and, as larger, global companies, tend to have diverse sources of revenue. The following is an abbreviated summary of the other eight points: be selective, hire only the top quality managers and go slowly, first, into alternative assets, into making tactical bets, into Japanese equities, into emerging markets, into emerging markets currencies, maintain deflation hedges, consider gold and finally increase inflation protection slowly.

This is a far cry from equities, bonds and cash. We have an equity bias because historically the best returns have come from equity-oriented portfolios. For the period 1901 to 1997 stocks have returned 6.9% after inflation while bonds have returned only 2.2% after inflation. At the present time, extremely low interest rates make bond investing very risky. We'd pick cash rather than gold. We believe that the high quality managements running the high quality companies we pick for our clients' portfolios, as large, global companies, have to deal with issues in emerging markets, Japanese competition and investment, currency issues, inflation or deflation and potential catastrophic events, where gold is meant to shine. Through our investment choices, we believe we are "hiring top quality managers" for these issues.

Recently McKinsey & Company reviewed the current state of the asset management industry and made some predictions about where existing trends would take the industry by 2015. Not unlike the asset allocation article above, the investment product trends were toward alternative assets, emerging markets and passive (vs. active) investing. (Although active investing remains at 60% of assets under management in 2015.) The company structural trends were toward beefing up the sales effort (the sales culture from our Spring newsletter), decisive action to restructure (current bank restructuring and downsizing) and the surprising growth of "independent asset managers" (those in the business of selling investment advisory services primarily rather than insurance, deposit accounts and loans or surviving on commissions). From these trends, McKinsey advised asset management firms, in brief, to shift investment emphasis toward solutions and outcomes for clients and develop conviction about decisions necessary to create a winning 2015 business model. We agree. We like where we are. Client success means Woodstock success and we believe we don't have to change our philosophy to be successful, as McKinsey defines it, in 2015. From our client-centered approach for asset allocation to our emphasis on solutions and outcomes for clients, we are oriented toward providing you with 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.◆

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

Don't Just Stand There - Ease!

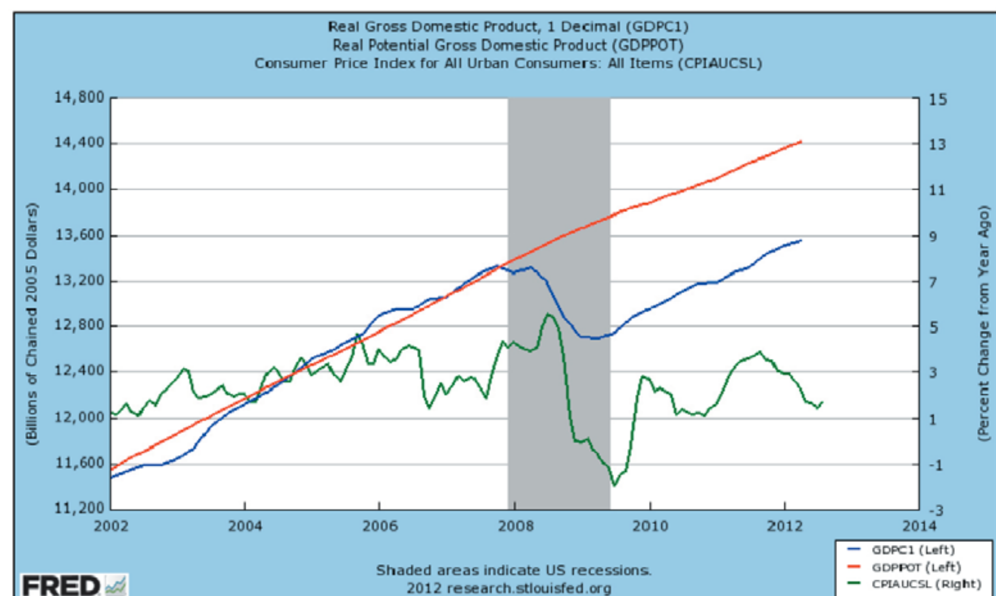
Thomas C. Stakem

After several months of speculation of will he or won't he, Federal Reserve Chairman Ben Bernanke launched Quantitative Easing version three, or QE3, on September 13th. It was rather a case of not enough good coming of current economic conditions (status quo) and with a sense of despair settling over the U.S. economy due to self-fulfilling fears of the "fiscal cliff" and the continuing confusion in Europe that some "term insurance" should be purchased. And while the indirect cost of the premium for this term insurance is incalculable, a do-nothing, stand pat strategy was deemed too high a risk given all the unknowns and uncertainties visible over the next six months. Mr. Bernanke must have concluded that he was the only adult in Washington and that, as a student of the Great Depression, he was going to use every bullet in his holster rather than allow the economy to stall further and risk imploding of its own weight in a downward spiral. The U.S. would not replicate Japan on his watch.

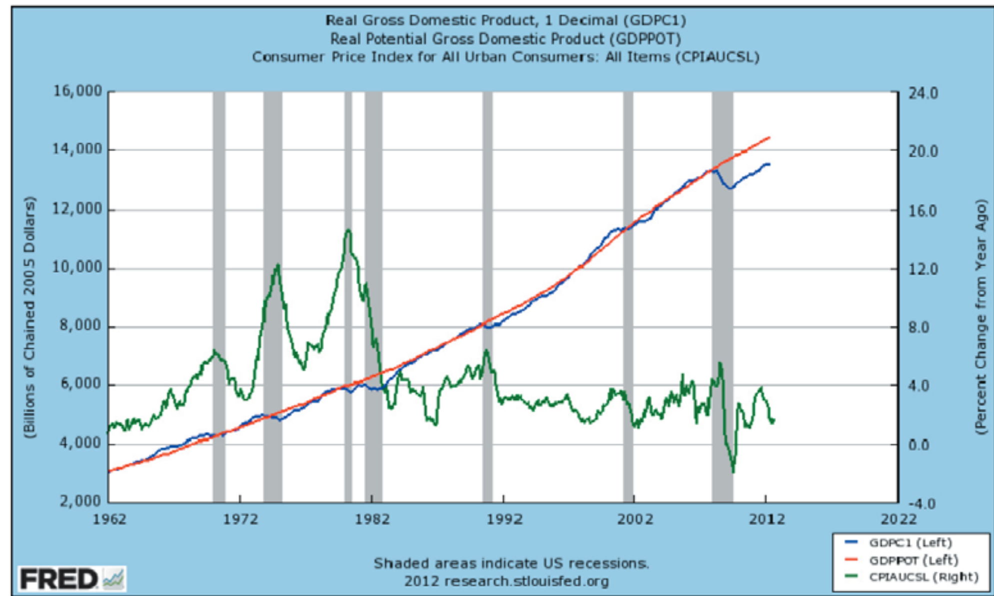
The Federal Reserve has a dual mandate in its administration of monetary policy – foster price stability and pursue full employment. A graph that captures this pretty well is shown below and is familiar to every economist. The country's current and potential real GDP are plotted on the left axis while the nation's CPI (consumer price index) experience (Y-o-Y change) is plotted on the right axis. It easily shows plenty of "economic runway" and a manageably low rate of inflation. By the end of the last recession (June 2009) there was a trillion dollar gap between current and potential real GDP or 7%-8%. It has narrowed to about $800 bns. (~6%). However, at recent growth rates this is five to six years of growth that will forever remain potential unless faster growth begins soon. And any annual growth rate lower than 1.7%-1.8% results in the GDP gap growing. Pondering this kind of data day after day undoubtedly motivated Mr. Bernanke to take action and to try and change the tepid trajectory of economic activity which is what he hopes QE3 will do.

For perspective, a fifty year timeframe of this graph (see p.3) only serves to highlight how tightly correlated U.S. real GDP has been with potential GDP. It is clear that we have never had as much "slack" as we have had in the last few years. This slack also represents a lot of unemployed labor and other unused resources. The concern is that chronic large GDP gaps produce chronic unemployment and a backlog of workers whose skills are obsolete after multiple years of unemployment. As a policy matter, revving up GDP growth was a necessity for Mr. Bernanke.

Continued on Page 3



Would you prefer to receive the Woodstock Quarterly Newsletter via Email? Please contact your Portfolio Administrator, or email hperry@woodstockcorp.com, and we will send them to you electronically going forward. Thank You!

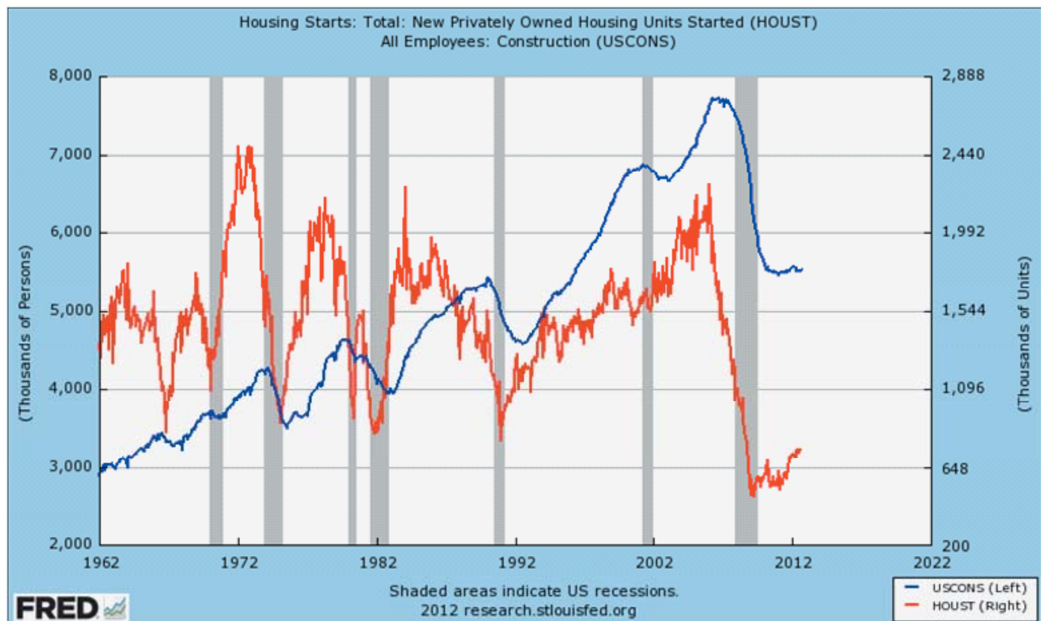


It certainly is not an earth shattering assertion that there are many gaps in the system. GDP, employment, corporate profits, federal and state tax receipts, etc. would all improve with faster GDP growth. Labor (wages paid) would be the biggest beneficiary followed by tax receipts, profits, dividends and retained earnings.

Housing & Construction

A significant part of the slack resides in housing activity and the associated construction employment. Today's civilian labor force numbers 155 million (12.1 million are unemployed or 7.8%). Every 1.5 million drop in the ranks of the unemployed lowers the rate 1%. Getting to a 5% unemployment rate means reducing their rolls by another 4.5 million. If the structural changes in the U.S. economy don't prohibit this from occurring, one of the likeliest contributors to such a large number has to come from construction-related employment. QE3 is laser focused on housing, a key driver of construction employment. Lowering the thirty year yield on mortgage securities is the goal of QE3 and its $40 bns. a month open-ended stated objective. Lower mortgage costs combined with a further rise in household net equity in real estate would stimulate housing to the benefit of construction activity and construction-related employment. The following chart shows that there are 2.2 million fewer construction jobs today than in existed in 2006. Little progress has been made since the November 2011 low (up only 70,000 jobs). Progress in reducing unemployment toward the 5% level will need a big contribution from construction – it could lower the rate by 1%.

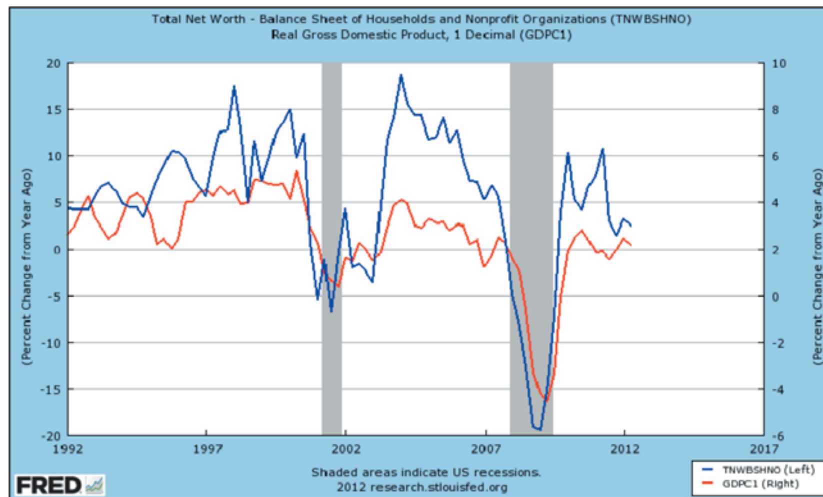
Continued on Page 4



Don’t Just Stand There - Ease! (cont.)

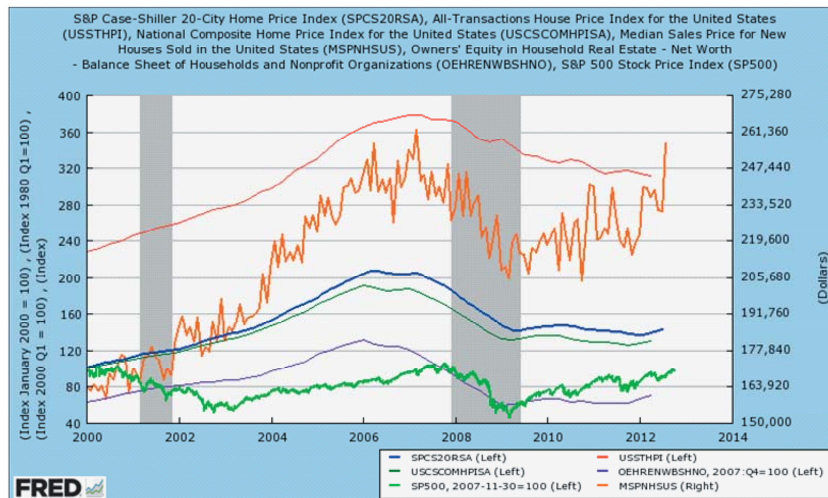
The above fifty year chart of housing starts and construction employment captures the cyclicality of the data but more importantly shows the vigor of housing starts coming out of recessions – except for the most recent experience. Too much inventory, unavailable credit, reduced housing turnover because of the stagnant job market and negative home equity are all reasons why housing starts are less than the 1.4-1.5 million average over this time period. Affordability has improved and, with the prospect of lower mortgage rates flowing from QE3, a brighter outlook for housing is in prospect provided the national employment picture stays constructive. Here is where resolving the “fiscal cliff” is so important.

Mr. Bernanke is counting on financial asset holders to grow the economy. People have to feel better off for consumer confidence to improve. Their net worth needs to trend higher if economic prospects are to become more vibrant. The net equity in our homes and the value of stocks in portfolios constitutes essentially all of household net worth. Home owners and holders of financial assets typically benefit when periods of monetary easing occur as financial asset prices respond before the real economy. QE3 is expected to help on both fronts – housing and stock prices – before it helps with the real economy.



It would appear that one’s feelings about net worth coincides or slightly leads real GDP performance (see above chart). With the U.S. economy really in need of assistance to boost growth it seems clear that Mr. Bernanke also shares a belief in the positive influence of net worth accretion on his mandate to lower the unemployment rate via a more vigorous economy. Have people feel 10%-20%-30% wealthier and perhaps good things will happen to the economy as they spend and invest.

Drilling down into one of the drivers of home owner equity is the trend in home sale prices. The chart below highlights the improving trend in the median price of new homes sold. This is a hopeful sign that the other national home price indices shown, which have been stabilizing, may begin to turn up in the near future. The median new home sales price in August was +26% (+$53,000) versus its October 2010 low. Coupled with an S&P 500 that is +114% from its March 2009 low, the outlook for household net worth trending higher is good particularly if QE3 positively impacts financial asset prices.



Don't Just Stand There - Ease! (cont.)

Unintended consequences?

Past episodes of QE have included food inflation (even shortages) around the world that negatively impacted inflation and economic behavior in places like Mexico and China. Some foreign countries perceive QE as a form of currency warfare, with Brazil among the most vocal critics of past QE efforts. QE3 is bound to unleash some of these charges and criticisms. However, thus far the dollar is not cooperating as it has risen 1% (since September 13) in contrast to the 5% and 3% declines in the first two QE's. Most commodities are also down since QE3 was launched so perhaps there's a chance that this time will be different.

How will we know if QE3 was successful or worth it?

Three weeks into the Federal Reserve's third dose of quantitative easing in four years, QE3 has been a bust. The dollar is up almost 1%, crude oil is down 6% and commodity indices are down 2.5%. Ten and thirty year yields have fallen 11-12 basis points. Mortgage rates have declined 25-65 basis points and are perhaps the clearest evidence of the influence that a $40 billion a month buyer for several years can have on the $4 trillion mortgage market. Getting the new home construction market on a stronger growth path is one of the clearest ways to get construction related employment to recover.

	QE1	QE2	QE3
	Nov 08 - Mar 10	Nov 10 - June 11	Sept 12 - future
S&P 500	36%	10%	-1%
EAFE	38%	5%	-1%
Emerging Markets	94%	0%	-1%
the $	-5%	-3%	1%
Euro	4%	3%	-1%
Oil	68%	13%	-10%
Gold	36%	12%	2%
Silver	70%	43%	5%
DBC commodity ETF	4%	13%	-5%
10 yr Tsy yield	23%	23%	-6%
30 yr Tsy yield	30%	8%	-4%
30 yr mortgage	-1%	16%	4%

Summary

The Fed is the only policy lever in town with Congress and the Administration too focused on re-election to ever worry about fiscal cliffs and a decelerating economy. QE3 is designed to impact how individuals manage their balance sheets (investment holdings) in exchange for an eventual positive effect on the real economy, employment levels and worker wages. Creating a feeling of greater wealth, as the theory goes, would eventually feed its way into current consumption – buying cars, homes and after enough time has passed a multiplier effect would compound this effect into greater economic velocity – GDP, employment and inflation.

QE3 could be a bigger capital markets (stock/bond markets) event than a real U.S. economy event. That's not much of a prediction since QE1 and QE2 were both considered non-events on the real economy. Over the last five years we have averaged 1.9% GDP growth and it's hard to detect much of a positive GDP fillip from the 2 rounds of easing over the last four years. This observation does prompt the question: where would the economy be without all the monetary and fiscal stimulus that has been thrown at it? Investors may not always consciously struggle with this issue but it does manifest itself in valuations. The S&P 500 trades at 13x EPS while the bond market trades at 60x (reciprocal of a 1.6% ten year yield). Another way of expressing this is the stock market has an equity risk premium near 6% versus a median of less than 2% over the last fifteen years in a range of +7% to -2%. A doubling of the ten year yield and a halving of the ERP (equity risk premium) would still justify a 1,540 S&P 500, +7% from recent levels. While this would not be a new all time high (1,565 in October 2007), investors could live with this kind of performance over the next year. And it might even help the real economy. ◆

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

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

It's October 2012, Do You Know What Your Estate Plan Says?

Henry P. Phippen

Singer Whitney Houston, author Michael Crichton, actor Heath Ledger and many other celebrities and "ordinary" citizens, have died with incomplete, outdated, and even no estate plans. This has often led to family disharmony, and in many cases, public bickering and lawsuits. It did not have to be that way for them, and it should not be that way for you.

No matter how young you are, or how small or simple your assets may be, a well thought out and current estate plan is critical to making sure that your assets are handled appropriately in case of incapacity and are passed under your wishes at your death. Therefore, it is important to have a valid will, a health care directive, a trust (if you wish to keep knowledge of your wealth out of the public domain), and even some form of power of attorney. To make sure that your documents will work as planned, the services of a competent legal professional should be utilized.

Initially, a thorough documentation of all your existing assets and how they are titled should be undertaken. Is real estate held in individual name or jointly with another? Is life insurance owned outright or an asset of a trust? Do you have an investment management account or a living trust?

You should take into consideration where you want each of these assets to go at your death. There are possibly several variables to evaluate, including relationships, personal interests of beneficiaries, and financial and tax efficiency goals. Sometimes, the personal variables can be in conflict with financial and tax efficiency and need to be resolved.

You should consider how you wish to get these assets to the beneficiaries. Do you want to leave them outright or in a trust? Will there be joint ownership with another? Proper titling of assets during your life will see that your assets pass as you wish. If your assets include life insurance, a retirement plan or any other contract, there should be both primary and secondary beneficiaries listed.

Once these steps have been completed, you ought to have a framework for your estate plan, but there are a lot of key decisions that still need to be made. The choice of trustee, executor, and attorney-in-fact should be made for reasons of competence and trustworthiness, not for friendship or fear of hurt feelings.

The role of trustee or executor requires knowledge, skill, and potentially lots of time and should not be chosen without careful thought. In addition, communication of these roles with the individuals selected is important so that there is agreement to perform the duties, as well as no surprises. Selecting a health care agent typically involves communication with the agent of your health care wishes and the confidence in the agent that your wishes will be followed, regardless of their personal preferences.

Once your documents have been drafted by a competent legal professional, it is important to monitor your plan as time marches on, and execute amendments as necessary. Changes in tax and estate laws can cause havoc to what was initially a solid, well-crafted plan. Changes in life circumstances (marriage, divorce, children, remarriage, etc.) need to be evaluated for how they impact an existing plan. For instance, marriage invalidates a will for an individual who was unmarried at the time it was drafted. In addition, the death of a trustee, executor, attorney-in-fact, health care agent, and even a beneficiary can cause issues with a best laid plan for obvious reasons.

Even with an up-to-date plan, it is important that a trusted individual be aware of the location of your important documents, as well as the professionals with whom you do business. This should include legal counsel, investment advisors/mutual fund companies/brokers, tax accountants, insurance agents/companies, and other service providers. Furthermore, information on any bank accounts, mortgages, credit cards, and any other financial affairs should be available. And in this internet-based world we live in, having the information available to access email accounts and online banking accounts should not be overlooked.

While an involved process, the peace of mind for you now and for your loved ones later is worth this effort. ◆

Henry P. Phippen, Director, Woodstock Corporation

Tax Update

Jeanne M. FitzGerald

I. Patient Protection and Affordable Care Act

The Patient Protection and Affordable Care Act ("PPACA") was enacted to provide quality, affordable health care to all Americans. The PPACA, also referred to as the Affordable Care Act requires applicable individuals to carry minimum essential health insurance for themselves and their dependents. A penalty will be imposed on those who fail to carry the required coverage.

Individuals who are covered by employer-provided health insurance or by Medicaid, Medicare, and certain other government health care programs are generally deemed to have minimum essential coverage. This individual mandate is scheduled to be effective in 2014. PPACA's provisions are intended to be funded by several new taxes.

A major source of new revenue includes a broadened Medicare tax. All wages are currently subject to the 2.9 % Medicare payroll tax. Employers and employees each pay one-half of the tax or 1.45 %. Self-employed persons pay 2.9 %. The Patient Protection and Affordable Care Act (PPACA) imposes an additional .9 % Medicare tax on all wages and self-employed income over $250,000 for married couples filing jointly ($200,000 for single individuals). Employees will therefore pay 2.35 % on all wages over the above amounts. Self-employed persons will pay 3.8% on earnings above these amounts.

Beginning in 2013, a 3.8% Medicare contribution tax is imposed on unearned income. An individual is subject to a tax on the lesser of net investment income or modified adjusted gross income over the threshold amounts ($250,000 for married couples filing jointly and $200,000 for single filers).
Net investment income is the excess of the aggregate of the following items less any allowable deductions directly allocable to the income or gain:

- Gross income from interest, dividends, annuities, royalties and rents not derived in the ordinary course of any trade or business
- Gross income from any passive trade or business
- Net gain included in taxable income that is attributable to the disposition of property other than property held in a trade or business that is not a passive activity

II. Estimated Tax Payments

Some individuals have to pay quarterly estimated taxes or pay a penalty on the amount underpaid. Self-employed individuals, retirees and nonworking individuals must often pay estimates if they expect to owe tax of $1,000 or more to avoid the penalty. Employees may need to pay them if the amount of tax withheld is not sufficient to cover their tax liability. Individuals with substantial investment income may also need to make estimated tax payments even if they have taxes withheld from their wages. Usually, there is no penalty if your federal estimated tax payments plus withholding equal either 100% of your prior year's tax liability or 90% of your current year's tax liability. However, individuals with adjusted gross income in excess of $150,000 must pay either 110% of the prior year tax or 90% of the current year tax to avoid the penalty. ◆

Jeanne M. FitzGerald is the Tax Manager at Woodstock Services Company. You may contact her at jfitzgerald@woodstockservices.com.