WOODSTOCK

QUARTERLY NEWSLETTER

In This Issue:

Fall, 2014

The investment world is bombarded by the word "risk". An investment is more or less risky. An investor has a lower or higher risk tolerance. The accepted measure of an investment's risk is volatility: how much and over what time period an investment's market value fluctuates. An investor, however, may answer a quiz. "In daylight with no perceived traffic oncoming, would you cross a street against a red 'do not walk' sign?" We're reminded of the two question job satisfaction questionnaire: 1. Do you like your job? 2. Are you planning to leave your job? Both questions are trying to probe, inadequately, a complex decision-making process.

For an investment the standard risk measure, volatility, seems to give much weight to the participants (buyers and sellers) in the market place versus really evaluating the investment. At Woodstock if a stock we like suffers a valuation swing down because market participants find it out of favor, provided its story is still intact, we'll buy it, rather than reject it as too risky. On another tack, the private equity market is perceived to offer a "free lunch"[1]: enhanced return potential over established markets with low volatility/risk. However, the low volatility is really an artifact of hard to price assets. The market place can't/won't change valuations on these assets quickly so they look less volatile, versus daily pricing in the established markets. Knowing that a private equity portfolio of ten investments (stocks) expects two to succeed, six to languish in mediocrity and two to go through a bankruptcy-like experience, gives a better assessment of risk for private equity investments.

For the investor, risk is complicated and it is simple. It is complicated to determine your risk tolerance in the abstract when thinking about what could be a devastating actual event. It is simple because most of us lived through 2007-2008 and although a little foggier but with more euphoria, 1999-2001. Starting in the year before each crash, what did you do? Reading the financial news at the time provided the warnings about what was coming. We had plenty of advance warning; we just didn't know when. At Woodstock we kept doing what we were and are doing. Investing in high quality US stocks offers a good return and a measure of safety. At Woodstock we believe high quality US stocks are a "shallow risk" asset meaning they may suffer a loss of real capital but will recover quickly (several years)[2]. Of course, you know what a "deep risk" asset is. Think of those two private equity stocks that won't recover.

We do need to determine what financial risks a portfolio is taking. However, it is not a formulaic exercise. In the following article Adrian discusses our expectations for the world and US markets over the short term future. It is mildly optimistic. If reality isn't mildly optimistic, then in our judgment, you are also in the right spot at Woodstock: our succinct risk assessment.

We also have some very good news to share with you. After what became a broader geographic search than we anticipated[3] we have hired two investment managers. Their resumes are posted on our web site and summaries were added to our Form ADV brochure. We are very pleased to welcome Maureen Murphy and Larry Dooley to Woodstock. They both bring analytical skills as well as client skills to our firm. As you know our portfolio managers must do the three primary investment company jobs: research companies, build client portfolios and build strong client relations. We attempt to do a good job with all three.

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. If you know of someone who would benefit from receiving a copy of this newsletter, please let us know.

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

[1] *Ask your portfolio manager for this reference*
[2] *Ask your portfolio manager for this reference*
[3] *A job placement in Boston media generated resumes from around the US and the world.*

Off the Floor Boards

Adrian G. Davies

Many investors think the Federal Reserve will have to raise interest rates quickly to prevent inflation from taking hold, while others are worried that if interest rates rise too quickly, it will dampen economic growth. The Fed only just finished QE3 – quantitative easing – in October, and it generally seems to have worked. The capital markets are strong and the economy seems to be accelerating without inflation. Although monetary policy is still very loose, market participants and economists are debating how quickly the Fed needs to tighten in order to curb potential inflation. Almost everyone agrees that the Fed will raise rates sometime in 2015 – Fed Governors have suggested as much, but that says little about how steep the rate cycle will be.

Some have argued that interest rates have been kept artificially low by quantitative easing. They haven't been. After Quantitiative Easings 1 and 2 (QE1 and QE2) were concluded, interest rates fell. The May 2013 "taper tantrum" notwithstanding, interest rates have drifted down with the tapering of QE3 as well. Second, bond yields in Europe are for the most part even lower than they are in the US, while officials there have been debating whether or not to implement a QE-style program. Regardless of whether QE gets implemented in Europe or not, concerns of deflation have been driving rates lower. We'll discuss Europe towards the end of this article.

In the US, the Fed has primarily been concerned about the risks of deflation. The act of pumping a cumulative $3 trillion dollars into the money supply through QE1, QE2, and QE3 has been intended to offset deflationary pressures. Asset prices have increased, but traditional inflation metrics like the Consumer Price Index (CPI) have been modest. The CPI last clocked in at 1.7%, close to the Fed's target of 2.0%. We should not expect the Fed to be able to manage the CPI with more precision than that.

Now however, the economy appears to have achieved a level of self-sustaining growth. The Bloomberg consensus of economists is that the US economy will grow at a 2.9% to 3.0% real rate for the next several quarters. The housing market rallied before May 2013, fell, and rebounded earlier this year. The economy has added an average of 245,000 jobs a month over the past six months, a level it has not reached since the recession began. The economy has marched on through debt-ceiling fights, a government shut-down, and fiscal tightening. Much of Obamacare has been implemented. Banks seem to have put the worst of the regulatory implementations and fines behind them and are expanding their loan portfolios again. While there are likely to be some disruptions, like the wintery first quarter of 2014 which drove US GDP down 2.1%, the general trend in this country seems to be towards stronger economic growth.

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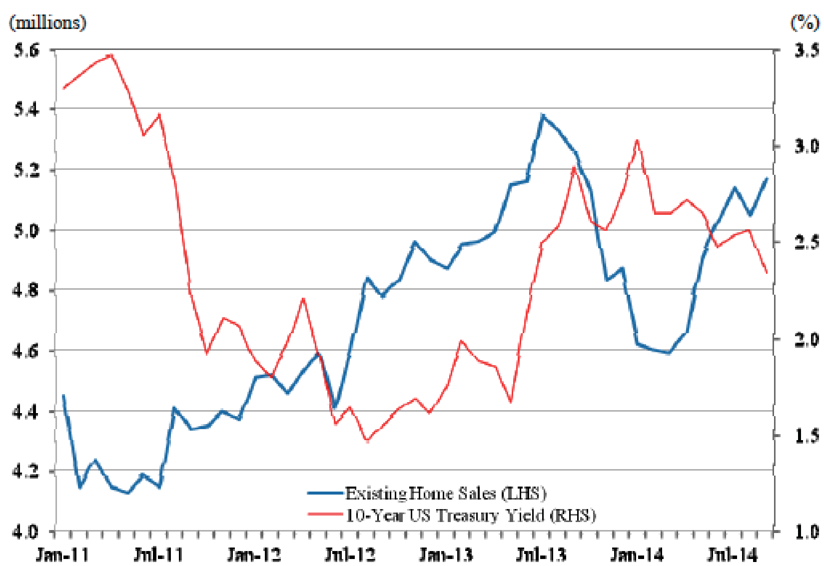
Existing Home Sales and 10-Year Treasury Rates

(Seasonally Adjusted, Annualized Rate in millions)



Source: St. Louis Federal Reserve, Baseline

Many, including the Fed Governors, seem to be anticipating an interest rate cycle similar to 2004-2006. From June 2004 through June 2006, the Fed raised the Fed Funds rate from 1.0% to 5.25% in 0.25 percentage point (25 basis point) increments every 6-9 weeks. Stronger growth and a rekindling of inflation would be two reasons rates would rise at this pace. The median forecast among Fed Governors is currently that the Fed Funds rate will rise to 1.375% by year end 2015, and 2.875% by year end 2016. Both the Fed's forecast and the previous cycle are faster than what the futures market is currently predicting.

The economic improvement may cause inflation to edge up over time, but it will most likely stay within a manageable range. With the unemployment rate falling from 6.7% in March to 5.8% by October, wage pressures have remained in the 2.2% to 2.5% range. During the 2004-2006 cycle, the Consumer Price Index ranged from 2.5% to 4.7%, while wage growth ranged from 1.9% to 4.0%. Despite higher inflation and rising rates, the stock market advanced at a compound annual rate of 7.5% over the two-year period.

In a typical business cycle, the Fed is "behind the curve" – the Fed Governors tend to raise rates well after inflation has made itself evident. If setting monetary policy is a trade-off between inflation and unemployment, the Fed's intention is to err on the side of keeping rates too low in so far as it facilitates maximum employment. The risk of raising rates too quickly is that it dampens economic growth. Starting the rate cycle in mid-2015 may prove to be uncharacteristically prompt. The bond market's "taper tantrum" is an illustration of what can happen if rates rise too quickly. In May 2013, then Chairman Ben Bernanke casually mentioned that the Fed might start winding down QE3. After the comment, ten year interest rates rose by more than a percentage point, and the impact on the housing market is evident in the chart on the previous page. The Fed probably does not want to instigate another mid-cycle housing correction at this point.

In the absence of stronger inflation, this interest rate cycle is likely to be more gradual than 2004-2006. Two factors that should help keep inflation low at least in the near term are the strong US Dollar and weak commodity prices. The US Dollar is up 8.1% since April on a trade-weighted basis. Relatively weak economies overseas not only are helping to push the Dollar higher, but are keeping a lid on commodity prices. It is noteworthy that the price of oil has gone down despite significant political turmoil in a number of oil producing nations.

Although there will be some inflationary pressures beyond the near term, we have come to appreciate the macroeconomic factors that are likely to keep them in check. These factors include generally high debt levels (student debt is but one problematic area), income disparity, and an aging population.

The chart on the next page juxtaposes the 2004-2006 cycle with the current cycle as forecast by the futures market, along with the Federal Reserve Governors forecasts. The Fed may be looking for market forces to drive up rates at the long end as an indication that it's time for them to move on the short end. The market has not yet obliged. The 10-year US Treasury rate finished the quarter at 2.49% while the 30-year finished at 3.20%. According to the Fed's most recent projections, the Governors expect the Federal Funds rate, a short rate, to "normalize" at 3.75% as soon as 2018. The bond market may not be discounting enough inflation, but market forces are telling the Fed Governors their interest rate forecasts are too high.

Europe and Japan

Meanwhile, Europe and Japan seem to be heading in the opposite direction: while the US is poised to tighten monetary policy, Europe and Japan are looking to further easing. The US Dollar has soared since April precisely because of the difference in monetary policy bias, and because the US economy is stronger than both Europe's and Japan's. The currency shift itself will have somewhat of an easing effect on Europe and Japan, encouraging exports, and implies slightly tighter conditions for the US.

Europe grew approximately 0.8% last quarter, with some countries posting declining GDP. The skirmish between Ukraine and Russia is one contributing factor dampening regional economic growth. Unemployment across the Europe Union averaged 11.5%. Inflation was about 0.4%, well below the ECB's target of 2%. Many of Europe's sovereign bonds are now trading at lower yields than US Treasuries because the region is facing a greater deflationary threat.

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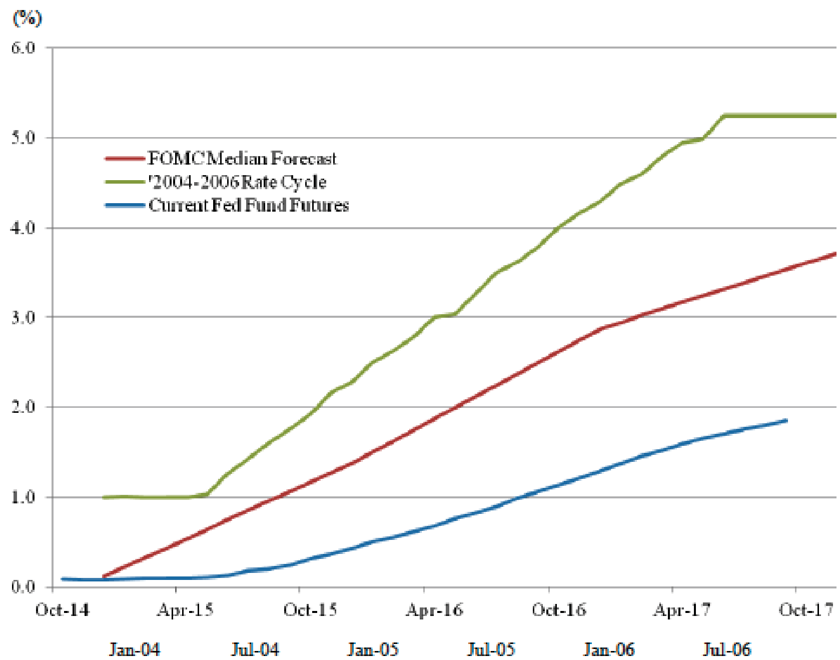
Federal Open Market Committee Expectations vs Futures and the Last Cycle



Source: Federal Reserve, St. Louis Federal Reserve Data, Bloomberg

What Europe probably needs more than quantitative easing is structural reform liberalizing markets. Structural reform is contentious and may never happen. Those resisting monetary easing argue that QE will only make it easier for Europe to put off economic reform. Certainly the standoff between officials in favor of quantitative easing and those against it is thwarting progress on either front.

European Central Bank (ECB) President Draghi has attempted to expand Europe's money supply with its Targeted Long-Term Refinancing Operation (TLTRO), whereby the ECB lends funds directly to banks at low rates. However, take-up of the TLTRO funds has been disappointing. The banks are reluctant to borrow as much as the ECB would like them to, rendering the program less effective. Since 2011, the size of the ECB's balance sheet has actually shrunk by about €1 trillion. Quantitative easing is Draghi's Plan B to stimulate economic growth.

The US's quantitative easing programs have involved the Fed buying both US Treasuries and mortgage securities. The ECB is banned from helping any individual country finance deficits, so its ability to conduct monetary policy by buying European sovereign debt presents a legal quagmire. There would also be contention over which country's debt to buy and in what quantity. Buying sovereign debt may still be Plan C. But first, the ECB has decided to buy asset-backed securities, covered bonds (mortgages and other debt pools that are backed by the creditworthiness of the issuing banks), and possibly corporate bonds. However, the overall markets for these debt instruments may not be big enough to enable the ECB to conduct effective monetary policy. It is unclear how the European economy will get out of its economic and monetary bind. The region seems condemned to suffer awhile longer before meaningful decisions can be made. Our expectations are low: we could always be surprised by more positive developments.

Japan's quantitative easing drove the Yen down 20% from 2012 into 2013 and drove the Nikkei 225 Index up about 75%. It jump-started the economy, culminating in phenomenal annualized 6.0% growth in the first quarter of this year. QE was not the only factor driving growth, as the Japanese went on a buying spree ahead of the country's consumption tax increase from 5% to 8% in April. Sales from the second quarter were pulled into the first, and Japan's second quarter GDP fell -7.1%. Economic growth is forecast to normalize, with the Bloomberg consensus of economists calling for 1.2% growth next year. Japan's quantitative easing program is one of three elements of Japanese Prime Minister Shinzo Abe's "Abenomics" plan

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to revitalize the Japanese economy. Quantitative easing is supposed to be accompanied by structural reform and fiscal reform, of which the tax increase is considered to be a central component. The Japanese government may follow through on a promise to raise the consumption tax a second time, from 8% to 10% in 2015. If the country experiences further sluggishness, the Bank of Japan will probably embark on another QE program. Given how dependent Japan is on imports, and how the market has already been defibrillated, we question how effective quantitative easing will be beyond a short term palliative.

Conclusion

Quantitative easing is probably best suited to providing short term economic stimulus. At some point larger or more prolonged QE would probably lead to a harmful loss of confidence in the currency involved. In the US, QE seems to have helped revive confidence by lifting asset prices and improving economic activity following the Great Recession. Since we have only returned to more normalized valuations and more normalized growth rates, we believe asset prices can appreciate from here. At 15.5x forward earnings, the S&P 500's P/E is very close to its long term average, and is cheap in the context of very low interest rates. There is much trepidation that a rising interest rate environment could be bad for stocks. If the US decides to tighten monetary policy further, it would be because economic growth is healthy. That interest rates might not rise as fast as expected could provide further support for the market.

Still more QE may be forthcoming elsewhere in the world. Japan has embraced QE, and Europe's central bank is fighting for the right to adopt it. Europe and Japan are likely to grow at slower rates longer term in the absence of further economic reform. We could stand to enact a few reforms in this country, and we can all appreciate that structural reforms are politically difficult to implement. We find solace in the fact that US GDP growth rates trend higher than those in Europe and Japan.

As we go to press, market volatility has increased. In recent trading sessions, both equity trading volume and volatility rose to their highest level in three years. The CBOE Volatility Index, or fear gauge, surged more than 30% on October 15 to a 12-month high. U.S. stocks have swung wildly, selling off and then partially rebounding as some investors have taken advantage of equity price weakness and increased volatility to hunt for bargains. While it is certainly prudent for investors to keep rational concerns in mind, one should not let emotions and the noise of 24-hour cable news headlines drive investment decision-making. At Woodstock, we try to take emotions out of investing and we stay focused on the long-term view. ◆

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Safeguarding Your Financial Information

Jeanne M. FitzGerald

Now more than ever, individuals need to take a more proactive approach to safeguarding their financial information. Specifically, protecting information as it pertains to individual taxation is not a subject to be overlooked. With the 2014 tax year coming to a close, here are a few things to keep in mind.

Identity Theft

Identity theft occurs when someone uses your personal information without permission to commit fraud or some other crime; often, a taxpayer's identity is used to fraudulently file a tax return to claim a refund.

IRS Telephone Scams

The IRS has reported an increase in telephone scams, in which callers pretend to be from or affiliated with the IRS. Victims are told that they either owe money or are entitled to a large refund. The IRS has warned that callers may be able to recite the last four digits of your social security number, or even imitate the IRS's toll-free number on your caller ID, to make it appear the call is coming directly from the IRS. Call the IRS directly if you suspect the phone call is a scam.

Phishing

Phishing is the attempt to acquire sensitive information (usernames, passwords, credit card info) by utilizing forms of electronic communication. Current strategies include phony emails informing taxpayers they are due a federal tax refund. The IRS does not initiate contact with taxpayers by email, nor request personal or financial information (PINS, passwords) by email.

Steps To Protect Your Identity

The following are some preventive steps to avoid becoming a victim of identity theft, as related to your taxes:

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1. Do not open emails or attachments, or click on links within emails claiming to be from the IRS.

2. Protect tax and other financial information stored in your home; shred documents containing personal information, and keep copies of tax returns in a locked file cabinet or safe.

3. Protect your personal computers and devices by using firewalls, anti-spam and anti-virus software, updating security patches, and regularly changing passwords for internet accounts that maintain any sensitive information.

4. Encrypt all emails containing personal or financial information.

5. Do not physically carry around your Social Security card or any document with your SSN on it.

6. Store your Social Security card in a secure location, such as a safe.

7. Resist giving businesses your Social Security Number if they ask for it – often this is not a requirement.

8. Review your credit report annually.

Woodstock strives to maintain your trust and confidence in our firm, and we are committed to protecting your personal information to the best of our ability. We will not disclose your personal information to anyone unless it is required by law, at your direction, or necessary to provide you with our services.. ◆

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