WOODSTOCK

QUARTERLY NEWSLETTER

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Summer, 2016

While we certainly repeat the regulator required mantra that past investment returns cannot predict future returns, we also believe it. Determining where to focus our investment research effort to increase the likelihood that future returns will match past returns is hard work. Could this effort with stocks be as simple as watching three financial or investment factors: yield (annual dividends divided by stock price) and the earnings growth rate combined with the psychology of the price/earnings ratio?[1] These are some of the basic tools we use for picking high quality stocks to go into Woodstock clients' portfolios.* The goal is to provide an equity-like return. Why are most investors in general faced with complex investment products or relatively expensive delivery systems? It is hard work for clients to cut through the complexity of products and expenses to find an equity-like return at a reasonable price. Woodstock was founded by managers at a broker/dealer providing complex products to their clients. These managers decided to invest their own families' accumulated wealth in a different manner: simpler, cheaper and successful at Woodstock.

How could we not briefly discuss "risk". The Financial Stability Oversight Council ("FSOC") in April 2016 published its report on firms' asset management products and activities.[2] "Activities" refer to actions taken by the firms themselves and "products" refers to what they provide to their clients. "Firms" refers to all four providers: banks, insurance companies, broker/dealers and investment management firms (such as Woodstock). The main "product" risk described was investment in "less liquid assets". A quick check of the financial news will reveal which firms and their products have had to restrict redemptions because their underlying investments are not liquid enough to meet redemptions at prices the managers are willing to accept: with Brexit, real estate funds in the UK; in the US recently, commodity funds. Woodstock invests in readily tradeable, high quality US equities. The "activities" section referred to the firms' use of leverage and how firms operate. Woodstock does not use leverage or borrowing in its investment activities for clients. We monitor our operations on a continual basis under SEC guidelines (See our ADV reports) and could be surprise audited by the SEC at any time. Probably more importantly we manage individual accounts. Our clients are not in pooled investment vehicles and securities are owned in our clients' names by their custodian.

To stray a bit from our normal topics, a recent article in the New Yorker magazine caught our attention, sadly. As part of an article on college student anxiety, a young women involved in campus protest activities nearing graduation wanted to "get as far away from the US as she could: 'working my piece of land somewhere and living autonomously.'" The US "is a sinking ship".[3] Of course, hyperbole by the student and the author are at play, but there is something missing on liberal arts campuses.[4] Comparative ownership and citizenship rights are missing ingredients. We're used to property ownership rights in the US where owning the surface rights grants air and subsurface rights but that is uniquely American. The US grants citizenship rights based on belief in a creed, not birth, again almost unique. Her expectations of life overseas are erroneously based on her American experience. Perhaps, the biggest miss in her education may be that she's never been taught that "free markets plus democracy equals freedom". Reading F.A. Hayek and our founding documents may not have been part of her curriculum.[5] It appears that her education will occur after college.

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**See the box 'A Long Term Market Forecast'*

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 & President*

Adrian G. Davies, CFA — *Executive Vice President*

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[1] WSJ, 12/26-27/2015
[2] Asset Management Update, Ropes & Gray, April-May 2016
[3] New Yorker, May 20, 2016
[4] What does Bowdoin Teach? Wood and Toscano, April 2013 & WSJ 4/6/13
[5] Is America Exceptional? N. Podhoretz. October 2012

A Long Term Market Forecast

Although the selection of particular stocks can be a complex and labor intensive process, forecasting market returns over a 10 year period may not be so difficult. In the short term the market can go any which way, but over the long term, the market is more likely than not to revert to its historical median Price-to-Earnings (P/E) ratio. Shareholder returns are generated by (1) dividends; (2) capital appreciation through earnings growth; and (3) some factor adjusting for this reversion to a historical P/E ratio. The dividend yield on the market is currently 2.1%. There are different ways to measure earnings (past or forecast, operating or GAAP), but historically, market earnings have grown at a 5% compound annual rate. Together, these imply the market will return about 7.1% per year going forward. The market is currently trading about 16.8x forward earnings, which compares to a historical median of 15.8x operating earnings according to Baseline. If the market reverts to its long term P/E ratio over 10 years, the multiple would lose about 0.6% annually, putting the market's total expected return to shareholders at about 6.5% per year.

We do our best to improve on these returns by picking high quality stocks expanding their market positions due to competitive advantages and superior managements. Superior market positions tend to result in faster growth rates, higher profit margins, and stronger balance sheets. And while we don't try to time the market, another key to our investment success is knowing company fundamentals well enough to know when the stocks are cheap or expensive relative to long term prospects.

Strange Times

Lawrence S. Foster

Over the last six or seven months the Fed has sent signals that the market should expect at least two and possibly as many as four rate hikes over the course of 2016 to try to "normalize" interest rates from the near "zero interest rate policy" (ZIRP) the Federal Reserve Board has held since 2009. Low interest rates have been intended to stimulate the economy allowing for companies to borrow cheaply to finance investment, create jobs, increase tax revenues, re-ignite moderate inflation, increase asset values and perhaps allow the government to reduce its borrowing costs. Despite this prolonged period of ZIRP, the Fed apparently does not feel the economy is strong enough to withstand normalization as we've had only one 25 basis point ("bp") increase in the Fed Funds rate and at its recent June meeting the Federal Reserve Board chose to wait for better economic news before announcing another 25 bps rate hike.

The Federal Reserve is not the only central bank that is struggling to normalize its interest rate policy. In fact, central banks in Europe and Japan have set their best rates below 0% – meaning that banks will have to pay the central bank to make deposits there. This is intended to encourage banks to put their deposits to good use by lending for

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economically productive purposes in their local economies. However, despite the best efforts of central banks, the economies of Europe, Japan and the US are challenged for growth and inflation has remained fairly subdued.

On Thursday June 23, 2016 the British electorate voted to turn back the clock and exit the European Union. While the details of its exit remain very complex and largely to be determined over the next 24 months, the British people have chosen autonomy over remaining in an experimental economic union of nations linked mostly by geographic proximity and a shared, but tumultuous, history. Though the vote was close, the large turnout and the clear majority is an ominous sign of discontent among the voting public there. France and Italy have similar populist movements that have been gaining strength.

Voter discontent is also alive and well in this country as evidenced by the success of Donald Trump, a political novice, and the near success of Bernie Sanders in their respective Presidential primaries. Both were considered fringe candidates and barely taken seriously by the political establishment 12 months ago. Their success was undoubtedly due to a myriad of factors. Typically voters react most vehemently to issues related to their well-being – are they better off today than they were 8, 10 or 12 years ago. Secondly, there seems to be an anti-establishment undercurrent unified by the notion that leadership in Washington has failed to serve a large segment of the electorate. Apparently, Middle America is not better off than it was 8 years ago and perhaps even 16 years ago. What has changed?

Globalization

Since the fall of the Berlin Wall in 1989 a lot of things have impacted the global economic landscape. The old Soviet Union collapsed under the weight of a poorly managed economy. Without a global adversary, the United States controlled lanes of trade around the world and free trade began to prosper where only limited trade had existed before. Eastern European countries that had been behind the Iron Curtain led the way and were eager to explore economic and political relations with the western democracies. Soon, other former Soviet satellites did the same. Before the end of the 1990s China had also liberalized its economy, most of Europe was united in an economic free-trade zone with a common currency (actually 2002) and North America likewise was joined in a free trade agreement. The Globalization genie was out of the bottle.

Technology has also played a major role in globalization in a wide number of ways. Communications have improved dramatically via email and satellite such that buyers on one continent can readily order goods produced in another. Inventories are more easily managed, supply chain management is more sophisticated and transportation is far more efficient now than it was even 20 years ago. Improved test and measurement systems using optical scanners, computer controlled machinery and other technologies have improved quality controls producing better outcomes with less waste. All these factors have contributed to making global companies and global trade far more efficient without sacrificing quality to the end user.

Globalization has elevated the standard of living for an enormous number of people. Goods and services that had been out of reach for large segments of the world's population, are now far more accessible. More efficient farming techniques exported from the United States have allowed the world to feed many more people with increased efficiency. Large segments of the underdeveloped world have better jobs and better working conditions than ever before.

In this country globalization has also brought many benefits though some might argue that the benefits have been unevenly distributed. Consumers have benefitted enormously from increased availability of high quality goods at lower prices. Inflation has been subdued here for the last 17 years. Apparel prices have inflated at less than 1.3% per annum since 2001. Food has averaged less than 4%, gas and electricity 1.8%. Overall core inflation has been under 2% for 8 of the past 15 years.[1] Technology has dramatically changed our lives. Our smart phones offer mobile computing power in excess of what desk top computers were capable of 15 years ago at a fraction of the cost.

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Furthermore, we can talk, text or email from just about anywhere in the world. We can control the temperature of our house in Boston while vacationing in Maine. Our phone can tell us where the closest Starbucks is and we can use the phone to pay for our latte!

Well managed companies have figured out how to do more with less and these efficiencies have rewarded management teams and shareholders. Though revenue growth has been hard to come by, efficiencies have driven margins to new highs in the last several years peaking at around 10% two years ago. The rates for borrowing have been low and lacking other investment opportunities, companies have bought back their own stock helping to lift (or at worst support) the value of outstanding shares.

So Why the Discontent?

Despite this economic and financial success, many Americans (and Britons?) feel left behind. Globalization and technology have contributed greatly to this dislocation. As markets opened up overseas, American companies could either expand operations domestically and pay higher transportation costs, or they could open plants in those markets. By choosing the later, companies built goodwill and paved the way for new markets' acceptance of their products. Furthermore, US labor is typically more expensive in terms of wages, benefits and regulatory compliance matters. Countries eager to attract foreign investment facilitated the process through tax incentives and access to land and labor. The chart below shows how this trend has affected US employment. While nonfarm payrolls have grown from 130 million in 2003 to 143 million today, the number of manufacturing jobs has dropped from near 15 million to 12.2 million. Gross Domestic Product, the broadest measure of the US economy grew from $12.3 trillion to $16.6 trillion over this same time period. Manufacturing and manufacturing jobs are less critical to our economy now than they were 13 years ago, unless you're a former employee of one of the plants that downsized or moved overseas. Over this same time period median household income has fallen from $56,000 to below an inflation adjusted $54,000 today.[2] So the jobs our economy is creating today are not keeping up what was possible even just 13 years ago.

Technology has also impacted employment as many of the most mundane and repetitive tasks have been automated. Robots don't require health care benefits or draw on pension plans and they are not represented in a collective bargaining agreement. Improvements in robotics and artificial intelligence will eat into the manufacturing employment payrolls in the years to come though estimates vary widely. When one considers the impact of globalization and technology, it's no wonder that Middle America and

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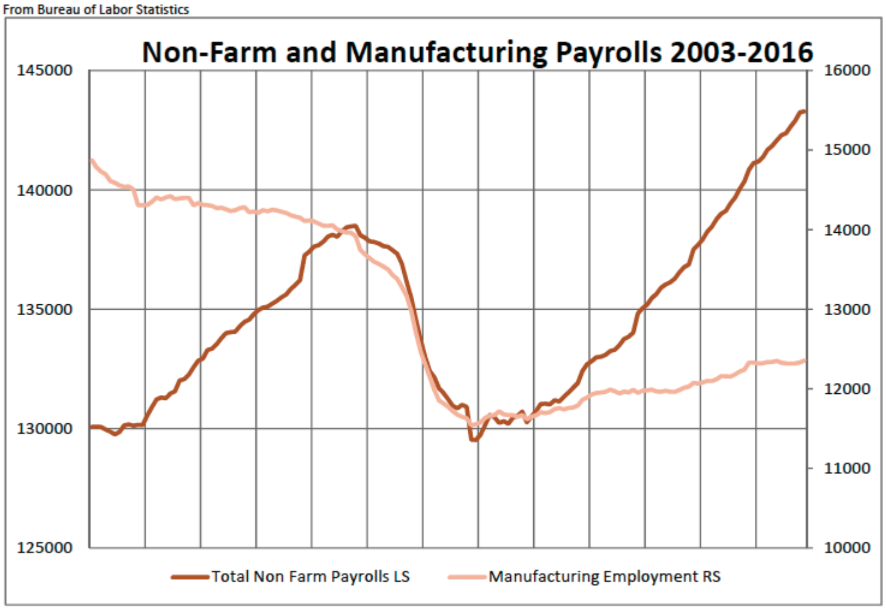
From Bureau of Labor Statistics



the middle class as we used to know them are anxious. The notion of a nation that consumes but does not produce is not only worrisome for those whose livelihood is dependent on production, but should also trouble us all.

The opening paragraphs of this article highlighted the Federal Reserve Board's current predicament. Interest rates have been low for an extended period, the Fed used quantitative easing to flood our economy with money and similar measures have been and are being tried in Europe and Japan – all with limited apparent effect. At best our collective economies have been limping along. Inflation according to government statistics has been modest. In the US employment has recovered though the depth of that recovery is uncertain based on a low participation rate.

The domestic economy while not full of vitality is doing okay. Our investment philosophy has served us well over the past 8 years and we won't stray from our mandate. Well managed US companies have provided decent returns and taken advantage of opportunities as they arise. It is a very good time to be invested with Woodstock. This writer would like to see the corporate tax rate brought down to levels competitive with other countries to encourage companies to build their next plant in this country and ensure that our citizens who want and can hold good jobs have that opportunity. Another 5 million individuals paying taxes will more than make up for lower corporate taxes and those individuals will spend more dollars thereby creating more economic opportunities. ◆

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[1] *Source: Baseline*

[2] *Bureau of Labor Statistics*

Tax Update

Our sister company, Woodstock Services Company, makes a tax planning guide available to our clients every fall. The 24-page report covers topics of interest to investors. Let us know if you don't receive a copy and would like one this fall.

As an investor reviews the lines on their own federal tax return a few lessons can be learned and situations appreciated.[1] Line 13, capital gains and losses, is at least a more manageable line for investors with individual accounts who are not owners in pooled investment vehicles. They get to choose when to recognize gain and/or offset with recognized losses. Much time was spent in our recent custodian conversion to make sure tax lot information was accurate. Using tax lot or specific share cost basis accounting is a substantial help in lowering taxes from recognized gains.

Many complex and high expense investment vehicles are better in the tax sheltered accounts. Vehicles generating consistent, recognized capital gains, such as some mutual and index funds, vehicles generating non-qualified dividends, such as REITs, which are owned in many value-oriented equity or equity-income mutual funds, are some.

Also, in general, US citizens whether here or abroad owe US taxes on their worldwide income, a unique US requirement. Renouncing US citizenship brings some tax consequences.[2] First, is the "exit tax". Tax law requires some wealthy taxpayers to file as if they sold all their worldwide assets on the day before renunciation even if they continue to own the asset. The capital gain tax rate is inflated for this purpose. Also, if renunciation is for tax reasons, re-entry to the US can be denied.

At Woodstock we are pleased to offer tax services and financial advice to interested clients. ◆

William H. Darling - Chairman & President
Jeanne M. FitzGerald - Tax Manager

[1] *Morningstar, March 2016*
[2] *WSJ, 12/23/15*

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