# Investor Quarterly

ROCKINGSTONE ADVISORS LLC

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*Founded by Brandt Sakakeeny, Rockingstone Advisors LLC is a boutique financial advisory firm providing asset management and corporate advisory services*

More of the Same

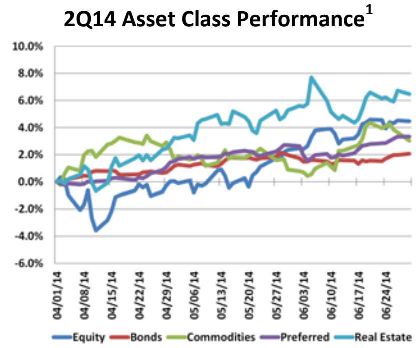
## 2Q14 Review

Financial assets recorded another strong quarter in 2Q14 amid declining volatility. Bonds extended their first quarter rally (the 10-year yield fell from 2.7% to 2.5%) fueling further gains in equities and especially income-producing securities such as Preferreds and REITs. Commodities also rose during the quarter on higher energy and metals prices.

Underlying macro data strengthened as the quarter progressed, admittedly from a very low base: U.S. 1Q GDP was -2.9%. But this figure was affected by the tough winter, and as spring arrived sentiment improved and the data followed, with especially strong figures out of the U.K. and U.S. The Chinese economy seemed to stabilize on better global GDP, leading to a firming of commodity prices in oil and in metals, though agriculture fell.

Corporate M&A activity also picked up in the quarter, adding more fuel to drive share prices higher.

**2Q14 Asset Class Performance[1]**




*Source: NYSE Arca*

Rockingstone's 2Q14 Performance

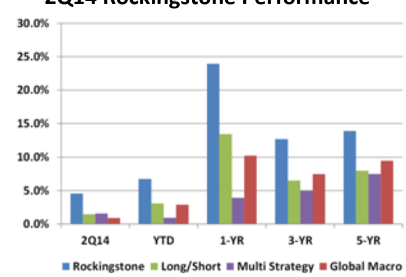
### A Game of Chicken

Rockingstone Advisors posted a gain of +4.6%. Despite some profit taking and sector rotation to undervalued names this quarter and last, our exposure has remained high, no doubt exceeding our benchmarks.

Valuations are stretched, in our view, but we have been reluctant sellers as valuation alone is rarely sufficient to trigger a sell-off; rather, valuation tends to dictate the severity of the correction once it arrives. In the absence of a clear catalyst we are inclined to continue to raise cash at a measured pace rather than hit the exit button and flee to the sidelines.

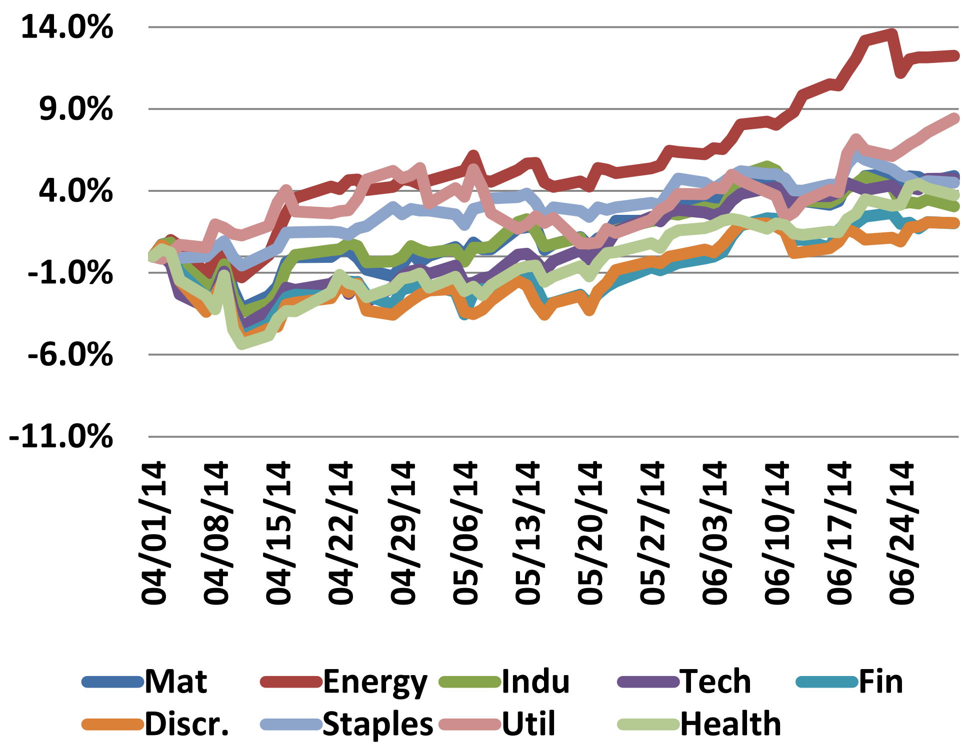
We now report our quarterly, YTD, 1-year, 3-year and 5-year returns.

**2Q14 Rockingstone Performance[2]**




*Source: Morningstar, DJ Credit Suisse*

***Please see our End Notes and Disclosures (page 7 of this Investor Quarterly) for important information regarding performance measures. Form ADV available upon request.***




## S&P SECTORS[3]

**ALL SECTORS GAIN**

The chart depicts the 2Q14 performance of the nine sectors comprising the S&P 500.

Energy stocks gain on geopolitical tensions; Utilities up on declining bond yields.

*Source: NYSE Arca*

### 2.1: 2Q14 Detailed Performance

Financial assets seemed to rise nearly every day, a slow grind higher for equity prices, a slow grind lower for bond yields, and somewhat mixed-- but decent returns-- from the commodity complex.

Despite a few tricky days when volatility spiked, in general markets just seemed to want to go higher, and volatility lower, with the CBOE VIX declining from 13.1 to 11.8 during the quarter.

The usual suspects of market angst: The Fed, earnings, Ukraine, and the Middle East all failed to upset the smooth upward trend of the market. Even some marginally hawkish comments from the Fed, lackluster housing data, as well as inflation data that we thought seemed a little high did nothing to derail the rally in financial assets.

Simply said, we think it's a little hard not to feel that the market appears overly complacent, particularly with the Fed's taper most likely occurring this fall and inflation perking up, particularly as employment has improved and factories have absorbed a lot of their excess capacity.

That said, corrections need a catalyst, and with low inflation, low interest rates and an improving economy driving accelerating corporate earnings, it is very difficult to figure out what could derail the current rally.

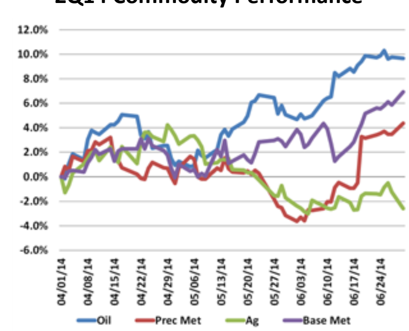
## Commodities

Despite poor performance in 2013, most commodities recorded a decent start to 2014 and continued that run through the second quarter, with the exception of agriculture, which gave up some first quarter gains due to better weather in Brazil (alleviating pressure on coffee prices) and a U.S. crop (corn and wheat in particular) that appears to be especially plentiful.

Oil recorded gains of close to 10% while base metals were up more than 6%. Precious metals rose more than 4%. The rise in oil and metals prices was probably due to a combination of better global growth (especially out of China) and ongoing tensions around Ukraine and the Middle East.

Please see our *1Q14 Investor Quarterly* for a detailed analysis of the commodity complex, and our expectations for future returns.

**2Q14 Commodity Performance[4]**



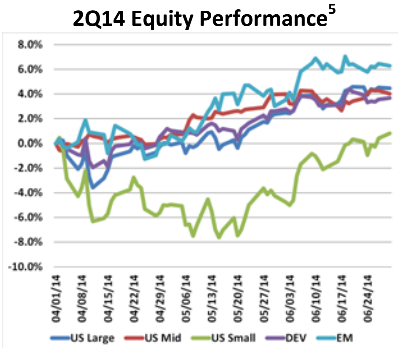

*Source: NYSE Arca*

## Equities

Equity markets again rallied in 2Q14, with most capitalizations (except for small cap) and geographies (even emerging markets) posting another consecutive quarter of gains, particularly in light of the exceptional returns posted in 2013.

Emerging markets equities led the gains for a second consecutive quarter, rising 6%. Large-cap equities, mid-cap equities and foreign developed were in a close tie for second, rising about 4% in the quarter. U.S. small-cap continued to lag as investors sought relative value in larger-cap equities and overseas.

**2Q14 Equity Performance[5]**



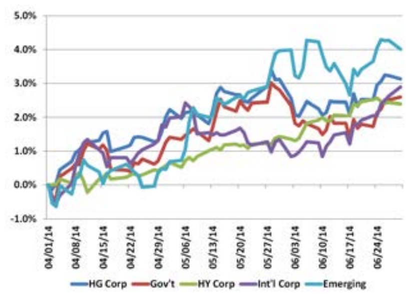

*Source: NYSE Arca*

## Fixed Income

Fixed income securities recorded a surprisingly solid quarter, rising about 2%, which is a fairly compelling annualized risk-adjusted return. This benchmark is roughly 40% government, 24% corporates, 23% agency backed and the remaining 13% cash and other.

We note "surprisingly" as we believe the data did not necessarily support a rally in bonds. The Fed's anticipated tightening should begin this fall and inflation numbers surprised to the upside, both of which should be marginally bearish for bonds. Spreads are very tight (narrowing during the quarter but widening slightly from lows), leaving minimal room for gains, in our view.

**2Q13 Fixed Income Performance[6]**




*Source: NYSE Arca*

Emerging markets bonds were the top-performing fixed income security for the second consecutive quarter, up 4%. Domestic and international corporates were tied for second, rising about 3%, and treasuries and high yield lagged, up about 2%.

### 3.1: Our 2014 Forecast

## Still Constructive, Just Less So

Half way through the year we have no changes to our 2014 outlook (please see following page). Last quarter we revised lower our GDP forecast and our PCE Deflator.

***Overview***

In general, we continue to be fairly constructive about the current environment. Low interest rates, an improving global economy, subdued commodity prices and relative political stability in the U.S. should allow for financial assets to record another decent year of gains, albeit nowhere close to the level achieved in 2013.

While the operating environment is reasonably similar to last year, asset prices were generally cheap at the beginning of last year; this year they are not, and even less so today, as stocks, bonds and commodities all posted strong first half gains.

In light of current asset values, consistent with the commentary last quarter, we see low-single digit gains in equities (S&P 500), a rise in the 10-year treasury, further strengthening of the dollar, and stable commodity prices.

The only change to our forecast last quarter was a reduction in our 2014 GDP estimate due to the horrible first quarter weather. Our revised estimate of 2.8% is probably a little high given the -2.9% print in the first quarter, but the pace of the economy seems to be improving and we see no reason now to reduce our forecast.

***Details***

All other forecasts remain unchanged. With respect to S&P 500 earnings, we maintain our current 2014 estimate of $117.51, which is below the Street's $120.08 (the first upward revision in over a year from $119.99). Our lower estimate reflects our assumption for greater capital spending in 2014, and hence lower profit margin growth than we assume most analysts are expecting.

We will note, however, that preliminary (38% of companies reporting) 2Q14 margins for the S&P 500 are at 10.1%, a 60 basis point improvement over 2Q13, and the first double-digit operating margin in history. The actual 1Q14 operating margin rose to 9.8%, about 30 basis points ahead of 1Q13. The ability of companies to continue to raise operating margins to record levels is a key underpinning of the current bull market.

Our S&P 500 earnings forecast for 2015 remains $128.22, below the Street's $136.01 (down from $137.26), which implies a 9% increase from 2014.

Our year-end target for the S&P 500 is 1925, or about 15x our $128.22 EPS estimate. This target implies flat to down returns for stocks for the remainder of the year. We are inclined to maintain this target as we believe

| Metric | 2014 | 2Q14 Revisions |
|---|---|---|
| US GDP | 2.8% | NC |
| S&P 500 EPS '14 RSA/Street | $117.51/$120.08 | NC |
| S&P 500 EPS '15 RSA/Street | $128.22/$136.01 | NC |
| S&P 500 | 1925 | NC |
| DJIA | 17350 | NC |
| 10-Yr. U.S. Treasury Yield | 3.3% | NC |
| Euro/USD | 1.25 | NC |
| Yen/USD | 1.15 | NC |
| Oil (WTI) | $98 | NC |
| Gold | $1,210 | NC |
| Inflation (PCE Deflator) | 1.7% | NC |

## KEY METRIC FORECAST

**FOR 2014**

No changes to our 2014 outlook for key investment metrics.

*Source: Rockingstone Advisors; Standard and Poor's*

that the acceleration in earnings is currently priced in to the market.

We continue to see U.S. 10-year treasury yields finishing the year around 3.3%, with a probable range of between 2.4% and 3.9%.

We expect the dollar to strengthen against both the Euro and Yen. Oil prices have firmed up on better global demand and rising natural gas prices, despite new supply and a stronger dollar. We expect oil to be confined to a fairly narrow trading range from here of between $95 to $110 bbl for WTI. Our target price for gold remains unchanged at $1,210, implying a slight decline from current levels.

### 4.1: Five-Year Asset Value Forecast

## A Scarcity of Cheap Assets

Longer term, according to our five-year asset value forecast (on the following page), we continue to believe that financial assets may offer historically limited real return potential, given current valuations, interest rates and profit margins.

We see foreign developed and emerging stocks offering the best absolute return potential within the equity markets, and emerging market bonds offering the best return within fixed income. We see muted return potential in other asset classes, and negative potential return within small- and mid-cap stocks and treasury bonds.

However, we continue to believe that there are opportunities to find undervalued securities within each of our asset classes.

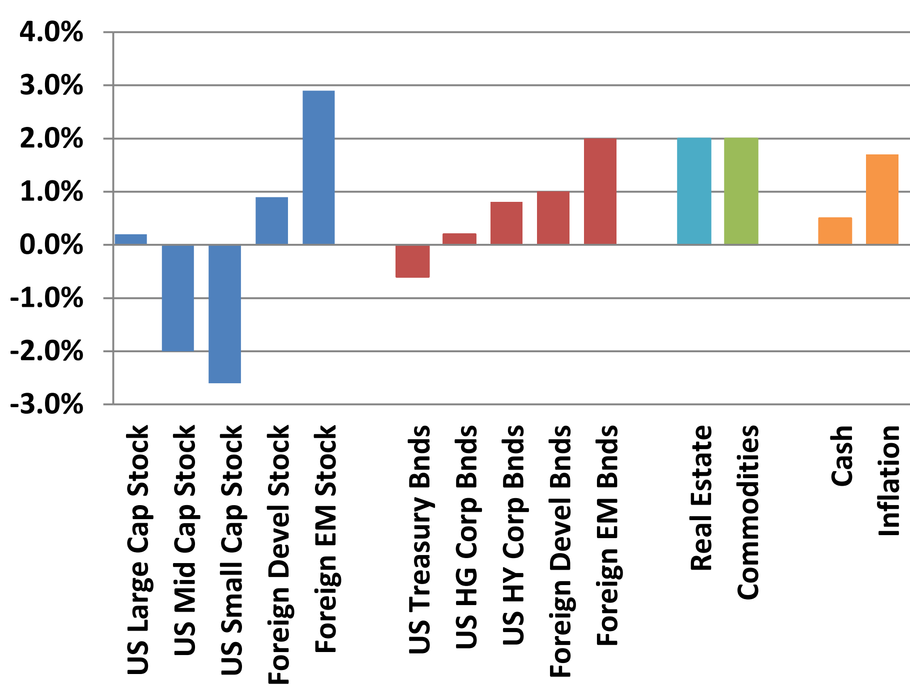
As we see mid-single digit gains in the major benchmarks in 2014, our research focus is concentrated on individual stocks that may benefit from global growth, with substantial operating leverage (high incremental margins), well-capitalized balance sheets, high returns on equity and compelling valuations.

**Large-Cap Stocks**

Actual S&P 500 EPS for 2013 were $107.30, an increase of 10.8% from 2012 EPS of $96.82. Presently, consensus (top down) earnings estimates for the S&P 500 are $120.08 for 2014 and $136.01 for 2015. The imbedded EPS growth rates are 11.9% for 2014 and 13.2% for 2015, which implies an acceleration in earnings growth from 2013 and also from 2014. The implicit Street P/E multiples are currently 16.5x 2014 EPS (vs. 15.7x last quarter) and 14.6x 2015 EPS (vs. 13.7x last quarter). Over the last 12 months, the S&P 500 is up roughly 24% while earnings have remained flat.

**Mid- and Small-Cap Stocks**

Consensus 2014 earnings for the S&P 400 (mid-cap) and the S&P 600 (small-cap) are $71.70 (down from $73.75) and $32.35 (down from $34.22), respectively, implying a P/E multiple of 19.5x and 20.6x, a decent premium to the S&P 500, a full multiple point higher than last quarter. Notably, 2013 earnings revisions have been higher only for the S&P 500; both the S&P 400 and the S&P




## 5-YR ASSET VALUE FORECAST

**2014 - 2019**

We update our 5-year valuation forecast based on 1Q14 results. We see limited real return potential for most financial assets over the next five years.

*Source: Rockingstone Advisors*

600 have witnessed lower 2013 earnings revisions.

Adjusting P/Es for growth rates, currently the S&P 500 trades at a PEG ratio 1.4x vs. the S&P 400 at 1.5x and S&P 600 at 1.3x.

Our assumption is that mid- and small-cap stocks have benefited from the relatively stronger economic recovery in the U.S., while large-cap stocks have suffered from anemic global growth. As global growth expands, particularly in Europe and Asia, we would expect large cap growth rates to accelerate, with concomitant upward earnings revisions—at least for 2014.

### 8.1 Portfolio Positioning, 2014

## Summary Views

The following section outlines our portfolio positioning ideas for this year and some of the potential risks we see.

**Equities**

We are constructive on U.S. large cap stocks and high-quality equities, neutral on mid-cap stocks and fairly bearish on small-cap stocks. We are also constructive on foreign developed and emerging market equities, the last of which has performed ahead of our expectations.

We expect correlations to continue to decline over the year and volatility to increase, particularly as the Fed begins to taper later this fall.

Our favorite sectors are technology, financials and industrials.

Within our industry sectors, we like mobile chips, airlines, staffers, banks and asset managers. We are reducing index holdings and adding more individual stock ideas that have underperformed or offer value.

Our top domestic equity holdings are Northstar Realty (NRF) and its recent spin Northstar Asset Management (NSAM), Apple (AAPL), New Mountain Capital (NMFC), Pfizer, (PFE), Intel (INTC), Sparton Corp. (SPA), Delta Air Lines (DAL), Yum Brands (YUM), Lorillard (LO), KKR Financial (KKR), Qualcomm (QCOM), Exxon Mobile (XOM,) Fireye (FEYE) and UTX (UTX). Since our last quarterly, we have added new positions in Robert Half (RHI).

With respect to international equities, we are overweight dollar-hedged developed markets (Japan mainly), as well as overweight China and Mexico unhedged.

We are paying attention to the recent declines in government yields across Europe, as deflationary pressures appear to be rising. Moreover, geopolitical uncertainty surrounding Ukraine and the potential impact on European fuel prices could weigh heavily on European equity valuations.

With respect to emerging markets, we continue to add additional exposure through index ETFs as well as a handful of individual names, such as Vale (VALE).

We have been short small caps for what seems like forever, and are finally ahead on a relative performance basis (though not absolute). We expect to add to our short position if we see a technical breakdown in the Russell 2K.

**Bonds**

We continue to like high yield bonds, bank loans, floating rate notes and other similar instruments. We are also short U.S. treasuries (yes it has been painful), and are neutral to slightly negative on high grade corporates.

Risks to our bond underweight would come from either slowing economic growth (a soft patch that seems to appear each spring) or ongoing subdued economic growth and high equity valuations that would allow bonds to outperform stocks in 2014. In fact, we expect high yield bonds to offer competitive returns to equities this year.

Risks to our high yield overweight and treasury short could come from a slowing of economic growth that would lead to wider spreads and higher perceived default risk, or an increase in hostilities around Ukraine, which would lead investors to seek safety in U.S. treasuries.

**Hybrids**

Despite the prospect of rising rates, we continue to own bond/equity hybrids, including convertible bonds and preferred stocks. While higher interest rates may dampen the performance of preferred securities, we like the fact that preferreds are over-represented among financials, as we continue to like that sector despite the recent decline in yields (and pressure on their net interest margins from such a move).

Risks to this group include the prospect of rising rates, as well as disproportionate exposure to financials.

**Commodities**

We continue to have oil and natural gas exposure, plus agriculture holdings (seed and fertilizer providers). We sold our gold in 2013 but own silver and now have added exposure to palladium (and platinum) through SWC. We like the palladium market on its own merits, but also as a hedge against Russian disruption.

**Risks**

Risks to our commodity position include a rising dollar that may put pressure on pricing, uncertainty regarding inventory levels, especially in China and other emerging markets, and weaker demand due to slower economic growth.

We see two principal risks to our current views: valuation and Fed exiting, and one latent risk: inflation. Valuations continue to seem full across most of the equity benchmarks, and most acutely in small caps; valuations seem even more stretched across most bonds categories, and most acutely in treasuries.

Fed exiting is somewhat related, as the Fed's purchasing of mortgage and treasury bonds has raised the price of these securities and lowered their yield; this in turn raises the discount value of all future cash flows, inflating the value of financial assets and contributing to the full valuation commentary above.

The latent risk is inflation given the combination of tightening labor markets, firming of commodity prices and absorption of excess capacity.

Of course the above risk view is predicated on our assumption of a growing economy; given the decline in global bond yields, the bond market is clearly signaling a slowdown in the global economy and rising risk of deflation, rather than inflation.

While these signals should not be ignored, we believe the preponderance of evidence from 1Q14 earnings reports points to slow, but steady, global growth.

## End Notes

Please Read Carefully

[1] Asset Class Performance chart depicts Equity (SPY ETF), Bonds (BND ETF), Commodities (DBC ETF), Preferred (PFF ETF) and Real Estate (VNQ ETF) price changes plus dividends and income during the period.

[2] Rockingstone Advisors performance charts depict the aggregate average of all accounts invested with a similar objective and risk tolerance during the entire return period; individual account performance may materially differ according to strategy and portfolio composition.

Returns are calculated using time-weighted method (TWM) and are weighted by portfolio assets. Public equity returns are calculated by Morningstar based on information received from our custodian, Charles Schwab & Co. Other investment returns, including private equity and real estate investments, are calculated based on valuation data from parties other than Rockingstone Advisors. Fixed income returns generated by private notes are recognized when the cash coupon is paid, rather than on an accrued interest basis. Annualized return is based on portfolios invested as of June 1, 2009. The sample set of portfolios has increased over time, which affects returns.

Our investment returns may reflect investment opportunities that are unavailable to all of our clients, for reasons including, but not limited to: (i) certain funds in which we invest are now closed to new investors; (ii) certain clients may not meet "accredited investor" standards; (iii) certain investments are available only to officers or directors of a business; or (iv) we may believe that historical returns most likely will not be generated in a specific investment and therefore are not committing new capital to a specific strategy.

Past performance is not indicative of future performance. Mean reversion is a powerful force, meaning periods of outperformance are typically followed by periods of underperformance. All figures are net of fees and expenses. Rockingstone's performance must be assessed in light of not just how the benchmarks performed, but also how much risk we assumed in generating portfolio returns.

This *Quarterly* is only for informational purposes and not a solicitation to buy or sell securities or as a source of specific investment, legal or tax recommendations. We are solely responsible for the content of this presentation. The information and statistical data contained herein have been obtained from sources we believe are reliable but cannot guarantee.

[3] S&P 500 sector charts represent XLY, XLV, XLF, XLU, XLK, XLP, XLB, XLE, and XLI with pricing data from NYSE Arca.

[4] Commodity Price Performance chart depicts Metals (DBP ETF), Base Metals (DBB ETF), Oil (DBO ETF) and Agriculture (DBA ETF).

[5] Equity Price Performance chart depicts US Large (SPY ETF), US Mid (VO ETF), US Small (IWM ETF), MSCI (VEA ETF) and Emerging Markets (VWO ETF) total return, including dividends.

[6] Fixed Income Price Performance chart depicts Intermediate Government (IEF ETF), High Yield Corporates (JNK ETF), High Grade Corporate (LQD ETF) and Emerging Markets (EMB ETF); all figures include price changes and interest earned over the period.

[7] Our 5-year forecast is updated quarterly and reflects our judgment on future performance based on current valuations and our outlook for earnings and macroeconomic conditions. We caution that predicting outcomes is inherently risky and subject to change.

## IMPORTANT DISCLOSURES

This quarterly is only for informational purposes and not a solicitation to buy or sell securities or as a source of specific investment, legal or tax recommendations.

Rockingstone Advisors is solely responsible for the content of this quarterly. The information and statistical data contained herein have been obtained from sources we believe are reliable but cannot guarantee.

Quarterly data priced as of June 30, 2014; most other prices and yields are as of July 25, 2014.

Please contact us if you have any questions, comments or concerns.

We are happy to provide the raw data and source links for any of the charts or tables in this newsletter. We thank you for your interest.

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