COMMENTARY

PRIVATE CAPITAL MANAGEMENT

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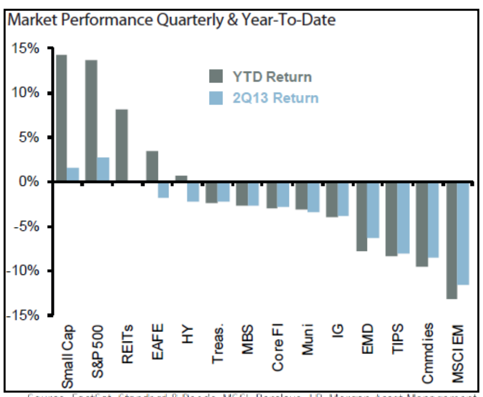
Second Quarter 2013

"Bullion doesn't pay interest or dividends, nor does it grow or expand by itself. That's the price you pay for tranquility."
-Pierre Lassonde

As the graph below shows, it has been a very mixed year so far for investments. The Dow Jones Industrial Average is having its best performance for the first half of the year since 1999, while Emerging Markets Stocks and Bonds, Commodities and Treasury Inflation Protected Securities (TIPS) are all deeply in negative territory for the year. An ETF report by Bespoke Investment Group shows Russia is down -15.8% year-to-date, while China is off -19.6% and Brazil fell -21.6%. Bonds faced strong headwinds during the quarter as the long expected rise in interest rates appears to have begun. Despite the recent pullback in equities, U.S. Large and Small Cap stocks posted positive gains for the quarter and are up nicely year-to-date. In this quarter's commentary, we will discuss some of these market segments as well as our thoughts on gold and the Big Mac Index.



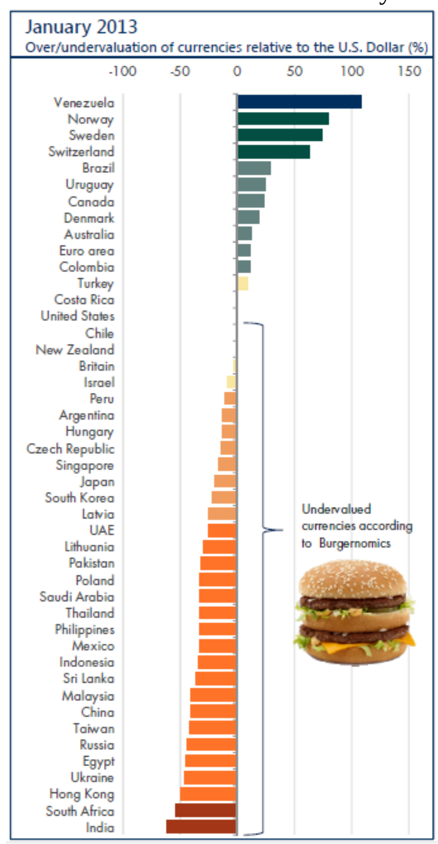
Source: FactSet, Standard & Poor's, MSCI, Barclays, J.P. Morgan Asset Management.

Has Gold lost its shine?

After watching a spectacular rise in the price of gold to \$1,900/ounce in September of 2011, the precious metal fell 36% to a three year low of \$1,200/ounce in June. During this rise and fall, there was an interesting performance decoupling of gold miners from the price of gold – historically the two have tracked each other fairly well. During our recent meeting with Charles de Vaulx, CIO of International Value Advisor, he noted that, historically, gold miners deserved a scarcity premium, as they were the only way for most retail investors to gain exposure to price movements in gold. Now, through the creation of ETFs, investors can own direct exposure to gold bullion, so this scarcity premium is no longer warranted. In addition, de Vaulx noted the miners' production costs have increased dramatically over the years to around \$1200/ounce. While gold is a good diversifier and can perform well during times of fear, we remain concerned that it has no economic engine. Gold generates no earnings or cash flow and, thus, pays no income to investors. The only way to make money in gold is to sell it to someone else at a higher price. Warren Buffett sums it up best: "Gold gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head." So, while we do have some exposure to gold in our portfolios, we think of it more as an insurance policy that we hope does not payoff.

The Big Mac Index

The Economist magazine publishes a fun guide to evaluate if currencies are at their correct level based on the theory of purchasing-power parity (PPP). The idea behind PPP is that global exchange rates should adjust over time so that a basket of identical goods costs the same amount in each country. For example, in January, a Big Mac cost \$4.37 on average in the U.S. and only \$2.57 in China. This appraisal implies the Yuan was undervalued by 41% versus the U.S. dollar. We hope you enjoy this light hearted look at currency markets.



Price is what you pay, value is what you get.

Investors often talk about the exciting economic growth and the better fiscal and demographic situations in emerging markets like China and India. It's undeniable that China's slowing GDP growth of about 7% is dramatically better than the recently revised 1.8% reading of U.S. GDP growth. So, while there is no question the emerging market economies have been growing much faster than the U.S. economy, many people would be surprised to learn that, during the last three years, the MSCI Emerging Markets index is up only 7.7% through June 30th, while the S&P 500 is up a whopping 59.4%. If an economy is growing quickly but the markets have already priced in expectation of that growth, excess returns will only be achieved if the growth rate exceeds what the market already expects. Excess returns come from making investments in countries and companies that exceed expectations, not by chasing the fastest growers. How much you pay for something will partially dictate the return you make.

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When the music stops… you get "Feral Hogs"

Bank of America Merrill Lynch estimates that over the last six years global central bank activity has produced: 520 rate cuts across the globe, $33 trillion in fiscal and monetary stimulus, half the market cap for global governments bonds yielding less than 1%, and the lowest U.S. government bond yields in 220 years.[1] Following the June Federal Open Market Committee meeting, Federal Reserve Chairman Ben Bernanke said that the economy is improving and that the central bank could begin to wind down (taper) its $85 billion-a-month bond buying program later this year. Having already lowered the Fed Funds overnight rate to near zero, the Fed started this bond buying program as a way to help stimulate the economy by driving down interest rates on longer dated Treasuries and mortgages. Interest rates on U.S. Treasuries and mortgages reached all time lows, making it less expensive for investors and companies to borrow money to invest in new projects, while also making it less desirable to hold safe assets such as CDs and government bonds. While it is unclear what the long term consequences of this quantitative easing will be, in the short term, it did help kick start the housing sector, which Bernanke noted had been a drag on growth since the financial crisis, but is now a support to growth. It should be noted that Bernanke emphasized that the central bank would be flexible in its approach to tapering bond purchases as it assesses the economy's health. This should mean the Fed's timing and approach will be based on the strength of the economy, not the calendar. So, while the music hasn't necessarily stopped, the record player has officially skipped and investors didn't hesitate to begin selling bonds.

As bondholders stampeded for the exits during the last 6 weeks, the rate on the benchmark 10-Year U.S. Treasury jumped almost 60% from a low of 1.63% in early May to a two-year high of 2.59% in June. To put this in perspective, the 0.46% move in rates during May alone marked the fourth worst month for government bond returns in two decades.[2] Treasuries and investment-grade bonds are on course for their worst year since the 1970s.[1] Dallas Fed President, Richard Fisher, described the market's reaction as the behavior of "feral hogs," which spontaneously organize to attack vulnerable prey.[3]

It is important for bondholders to understand that the 30+ year bull market in bonds, in which bond prices increased as rates steadily marched lower, has probably ended. The math behind the recent jump in interest rates is part of what made bonds unusually risky. For example, a 1% rise in rates from 1.50% to 2.50% is a 66% move, but the same 1% rise from 2.50% to 3.50% is only a 40% increase. Ultimately, higher interest rates will be better for investors, especially retirees who rely on income from their retirement savings. Unfortunately, getting there will be an unpleasant mathematical experience dominated by low and possibly negative returns in bonds.

In a rising rate environment, we believe the best offense in bonds may be a good defense. Being defensive in bonds when rates are rising is about managing interest rate sensitivity of a portfolio, also called duration. To put this in perspective, the iShares Barclays 20+ Year Treasury Bond ETF (TLT) has a very long duration of 16.8 and fell -11% from May 1st to June 17th. By contrast, the iShares 1-3 Year Treasury Bond ETF (SHY), which has a duration of only 1.9, fell just -0.37% from May 1st to its recent low on June 25th.

Generally speaking, stocks currently look more attractive than bonds, but simply selling bonds and buying stocks can dramatically affect the risk profile of a portfolio. Since 1941, the worst 1 year return on the S&P 500 was a 39% loss, but the worst 1 year return on bonds was a loss of only 5.1%.[4] So, while bonds look expensive versus stocks, we still do not believe short term bonds carry the same magnitude of risk that has been historically inherent in stocks.

Thank you

It has been eleven months since PCM became the investment management division of Guaranty Bank and Trust, and the results have exceeded our expectations. The ability to now offer clients access to a host of banking services has been very well received. In addition, our assets under management have grown nearly 45% to over $230 million. This growth has helped facilitate several strong additions to our team including Giles R.A. Fox, CFA, Adrian A. Duran and Amy L. Leck. Additionally, we upgraded our research software which facilitated the expansion of our quantitative process to cover the entire mutual fund universe. We owe a great deal of thanks to all of our clients for helping us to achieve so much. Thank you for placing your trust with Private Capital Management.

By the numbers…

Index	Close	2nd Quarter	Year to Date
S&P 500	1,606	+2.9%	+13.8%
Dow Jones Industrial Average	14,909	+2.9%	+15.2%
MSCI EAFE	1,638	-1.0%	+4.1%
MSCI Emerging Markets	940	-8.1%	-9.6%
Barclay's U.S. Aggregate Bond	-	-2.3%	-2.4 %
DJ|UBS Commodity	124	-9.5%	-10.5%

Data provided by Morningstar as of 6/30/2013

1 Tan, Kopin. "The Market Starts Taking Its Medicine." *Barron's Streetwise:*. N.p., 29 June 2013. Web. 03 July 2013.
2 Gross, Bill. "Market & Performance Summary, May 2013." *PIMCO.com*. Pacific Investment Management Company, LLC, n.d. Web. 03 July 2013.
3 Forsyth, Randall W. "A Fevered Finale." *Barrons.com*. Barron's, 29 June 2013. Web. 03 July 2013.
4 Emsbo-Mattingly, Lisa, Dirk Hofschire, Miles Betro, and Craig Blackwell. "Second Quarter 2013 QUARTERLY MARKET UPDATE." *Fidelity.com*. Fidelity Investments, n.d. Web. 3 July 2013.