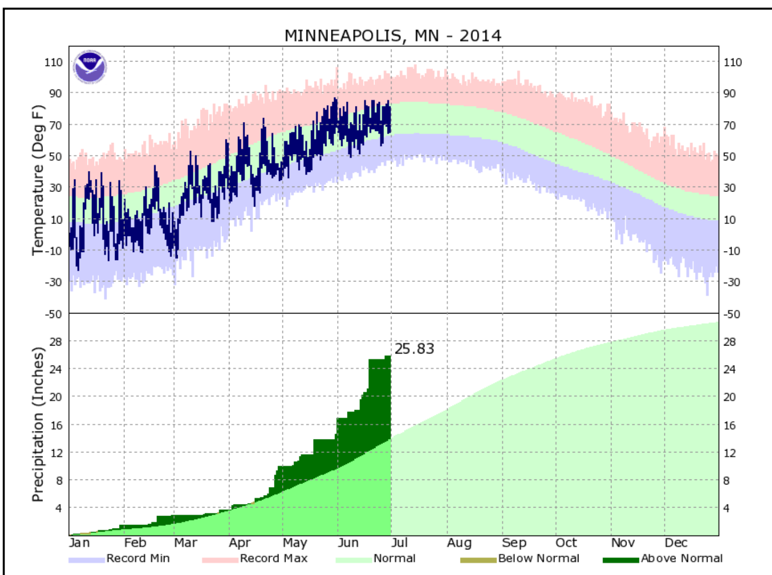
PERKINS
CAPITAL
MANAGEMENT, INC.

July 21, 2014

Dear PCM Clients and Friends:

We would prefer to write about something other than the weather in the opening paragraphs of these quarterly letters, but living in Minnesota that is usually not possible. In the winter months we are on the network news many times as the nation's "Icebox," and while we don't like that reputation, perhaps we deserve it. And that often gives us the opportunity to write about excess snowfall, such as we had this past winter. Recently, we have been on the network news again repeatedly as viewers are watching the floods in Minnesota as a result of record amounts of rain throughout the state, with the area around Minneapolis and the southern part of the state especially hard hit. June has gone into the record books with 11.36 inches of rain in the Twin Cities, almost matching the previous record of 11.67 inches set in 1874; normal rain for June in the Twin Cities is 4.25 inches, so you can see the immense difference. In fact, in one short 24-hour period we got 5 to 6 inches of rain. As shown in the chart, January-June total rainfall was 25.83 inches, easily passing the previous 1975 record total of 22.48 inches. The result of all the rain was a lot of flooding, but there would have been flooding this spring in some areas anyway, because of the record snowpack this past winter. The snow was so deep that Perk took pictures of the 6-foot high piles in his driveway that the snowplow created and emailed them to his California clients so they could see what he tried to describe to them over the telephone. Taken together, the result was record high lake and river levels, with the extreme flooding throughout the state resulting in road closures in many areas, making travel very difficult. Here in Wayzata, Lake Minnetonka is at a record level of 930.77 feet above sea level, and docks are under water, so brave boaters wade through water on the docks to get to their boats. And since docks are not all the same height, in some places the boaters cannot even get to their boats. And, to add insult to injury, most local lakes including Lake Minnetonka and Long Lake (where Perk lives) have established "no wake" water levels, which until reached requires boaters to move very slowly, about 5 mph. This caused great frustration, especially over the 4th of July weekend. Some didn't even bother to take boats out, a great disappointment during the traditional long boating weekend. But one person's



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misery can be another's pleasure, for one benefit has been the increased water level of Lake Superior to levels not seen for 15 years, a foot higher than last year and seven inches above average. This is beneficial as larger vessels can come into harbors now without scraping bottom. Ditto for sailboats, improving the quality of sailing, an important recreational activity on the Great Lakes, all of which have risen, just not as much as Lake Superior.

Water seeks the level equivalent to the level of the lake in areas that are near the lake. For example, the parking lot two doors east of our building on Lake Street is lower than the street, and as a result is full of water matching the level of the lake. We were astonished to see sunfish swimming in it, presumably forced up from the storm sewer. The picture of mallards sitting on a park picnic table is their idea of high ground. That will give you a clue on how much water there is all over. The floods caused damage, and the road closures were inconvenient, but it pales in comparison to the economic loss to the state's farmers, who have flooded fields and were unable to plant crops on a timely basis. As a result, some fields will never be planted and others which were, and then flooded, will have limited production.

A MESSAGE FROM PERK

On June 5, I was part of a four-person panel called "Grumpy Old VCs" held at the Minneapolis Club, sponsored by Rich Brimacomb as an event of his clubentrepreneur.com effort. Others on the panel were Norman Dann, Andy (A.J.) Greenshields, and John Trucano. This was great fun, as I have known the other panel members for almost as long as I have been in Minneapolis, nearly 50 years now.

Norman Dann has been in the medical device industry, particularly with Medtronic as a VP of Sales and Marketing, and SVP of Development, and along with A.J. Greenshields and Gary Stolz was cofounder of Pathfinder Venture Capital. A.J. was with First Midwest Corp. before joining Norm and Gary to start Pathfinder, and for a while was with Spell Capital, when I was also involved with Spell. John got into venture capital early on with Community Investment Enterprises, Cherry Tree Ventures and The Food Fund.

But before I go further, let's go back to the beginning of venture capital in the Twin Cities. One of the first venture firms in the nation was First Midwest Capital Corp, founded by Alan K. (Buddy) Ruvelson in 1959, when I came to Minnesota and about five years before I came to Minneapolis. I can't say exactly when I met Buddy, but it was early on and turned

into a long relationship with one of the great men of the Minneapolis investment community. Sadly, he is no longer with us. In 1961, with the help of Bill Norris, of Control Data fame, Northwest Growth Fund was started under the ownership of Northwest Bank. Bob Zicarelli, a fund manager at Allstate in Chicago, headed it for many years until retirement in 1988; he was succeeded by Dan Haggerty. I can tell many Zicarelli stories during his tenure at the Growth Fund, as it was called, which pretty well matched my years at Piper Jaffray (1966-1985) and we looked at more than one deal together. Ultimately, the fund moved to Palo Alto and changed its name to Norwest Venture Partners. And let's not omit Community Investment Enterprise or CIE, started in 1960 by Bill Dietrich and Gerry Simonson, whom I knew, as well as Don Soukup who came aboard later. John Trucano spent several years at CIE. The big thing that stands out in my mind about CIE was that it invested in Medtronic when Northwest Bank refused to lend the company any more funds. The company's banker, Don Shulteis, had continued to provide funding under penalty of losing his job, but did so anyway for a long while. He was one of the unknown heroes of the Medtronic success story. Without him or CIE, who knows what might have happened?

There would be more to add to this, I am sure, if I took the time to interview Norm, A.J. and John. But let's move on to the panel, which is what this is all about. Norm Dann started by answering the first question, which pertained to the difficulty today in financing private companies. He answered by describing how difficult it was to raise the money to start Pathfinder Fund, home to him, A.J. and Gary Stolz, who were the founders in 1980. It took a lot of time and effort to get even the first dollar. I remember giving Gary the names of some Wisconsin insurance company clients of mine, but the first investor was Aetna and the fund was only $10 million. Norm said there are several things today which impede financing for small medical companies—and that is the Federal Drug Administration rules that dictate the hoops that companies must jump through to get approvals. The time it takes is so extended and so much patience is required that individuals are not willing to wait for fruition, and VC funds take that into account by demanding a large share of the company pie. All four panel members agreed, and each added an insight into the question of the main difference in the current market versus many years ago when all panel members were active. The panel members did note that the venture funds today, many of which are on the two coasts, are large, making big commitments compared to the past.

All of the panel members have served—or serve today—on boards of directors and agreed that in their experience the most important ingredient in a successful company is management. The idea or the product is the reason the company is being financed, of course, and without it there would be no business plan and no reason for seeking financing. But the reason a company succeeds or does not, is most often the management. This may mean the leader at the top, the president, but he or she must be capable of leading a team, as it is the team at the top that makes the company succeed. But often that leader at the top must be changed, and sometimes the entire team. I made the statement that in each of the companies where I served on the board over the years, the board saw fit to replace the president, in several instances more than once. The other panel members agreed, and offered their own examples; I mentioned Proto Labs in Maple Plain, where Brad Cleveland, the founder and builder over about a decade of a very

successful company, has just voluntarily stepped aside so a seasoned executive could come in and take it to the next level.

In these paragraphs I have skipped over many of the questions given to the panelists and their answers. Rick Brimacomb has asked each panelist to answer a list of possible questions, and he may try to put it all together in print—and if this happens, hopefully, he will let me share it with our clients and others who read these quarterly letters. And, he has already asked us if we would be willing to do another panel this fall.

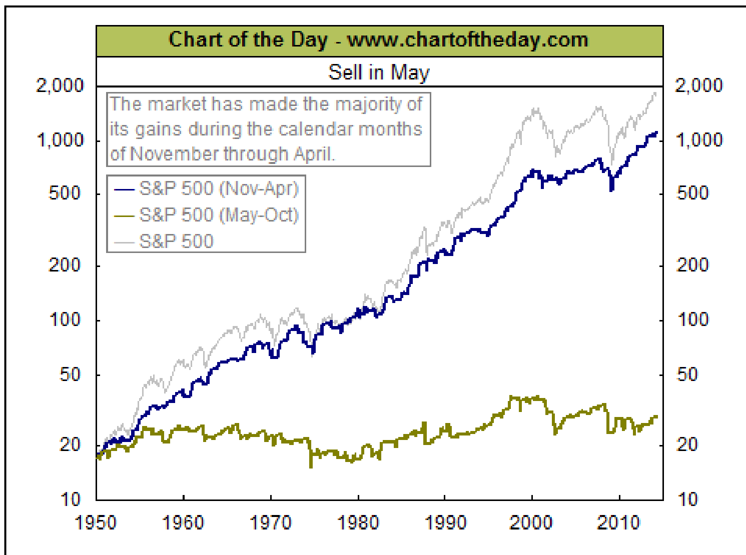
THE MARKET SCOREBOARD

Looking at the scoreboard two things are evident—first, about three-fourths of the gains for the first half came in the second quarter. Second, it was the small-cap stocks that achieved the worst performance for the first half, with the broader market averages at the top of the table, except for the Dow Jones Industrial Average, which wound up dead last. The Dow is an arithmetic average, so obviously some of its high priced component stocks did poorly. The broader market averages such as the S&P 500, Wilshire 5000, NYSE Composite, and the NASDAQ do represent the real first half as they were up within .50 basis points of each other. Small-caps were definitely the worst performers, well behind the other averages.

Indexes	% Return YTD 2014	% Return Q2 2014	% Return Q1 2014
Russell 1000 Total Return	7.27	5.12	2.05
Russell 3000 Total Return	6.94	4.87	1.97
S&P 500 Composite	6.05	4.69	1.30
Wilshire 5000	5.87	4.33	1.47
NYSE Composite	5.57	4.29	1.25
NASDAQ Composite	5.54	4.98	.54
S&P Small-Cap 600 Total Return	3.22	2.07	1.13
Russell 2000 Total Return	3.19	2.05	1.12
Value Line Composite	3.19	2.01	1.16
Dow Jones Industrial Average	1.51	2.24	-0.72

THE MARKET–LOOKING AHEAD AT THE MIDTERM YEAR

If you take the time to review our January and April 2014 letters (on our website), you will see that we have been expecting a market correction in this midterm election year. Every four years we have the Olympics, the World Cup, Congressional midterm elections and a stock market correction. Presumably, our readers are familiar with the "sell in May and go away" statement, which emanates from the fact that the market does its worst from May to October and best from November to April. The Chart of the Day, on the following page, reveals that the S&P during that May to October time frame was quite unrewarding, whereas the November to April period plotted against the S&P did better than the S&P for the year. This same information is presented numerically in Table 1, reproduced with permission from Hays Advisory and shows that the period we are now in, May to October of the midterm year is clearly the worst of the May to October periods of the other years,



as it has a negative return compared to positive returns for the other May to October periods. Likewise, Table 2, which shows the November to April returns, presents superior returns for the November to April time frame in the midterm period compared to the other six-month November to April periods. This four-year midterm correction cycle could have come early in the year, but since it did not, it likely will be later in the year, resulting in a bottom that presages the so-called 5th-year rise which has a record going back to 1886 with the exception of 2005. This is a powerful move, as the average gain in those fifth years was 29%. The chart on page six shows the power of the 5th year.

Table 1 – Sell in Midterm May
Election Cycle & May-Oct Returns

Period	Post-Election Yr 1	Mid Term Yr 2	Pre-Election Yr 3	Election Yr 4
1929-1932		-32.0%	-30.2%	19.4%
1933-1936	7.7%	-15.8%	34.3%	25.0%
1937-1940	-24.8%	35.8%	17.5%	-9.1%
1941-1944	2.0%	23.0%	2.8%	7.7%
1945-1948	12.2%	-20.9%	5.8%	6.8%
1949-1952	8.8%	8.1%	2.3%	5.1%
1953-1956	-0.3%	12.1%	11.5%	-5.8%
1957-1960	-10.2%	18.2%	-0.1%	-1.8%
1961-1964	5.1%	-13.4%	6.0%	6.8%
1965-1968	3.7%	-11.9%	-0.8%	6.1%
1969-1972	-6.3%	2.1%	-9.4%	3.6%
1973-1976	1.2%	-18.2%	2.0%	1.2%
1977-1980	-6.2%	-3.8%	0.1%	19.9%
1981-1984	-8.3%	14.8%	-0.5%	3.8%
1985-1988	5.6%	3.6%	-12.7%	6.8%
1989-1992	9.9%	-8.1%	4.6%	0.9%
1993-1996	6.3%	4.7%	13.0%	7.8%
1997-2000	14.1%	-1.2%	2.1%	-1.6%
2001-2004	-15.2%	-17.7%	14.6%	2.1%
2005-2008	4.3%	5.1%	4.5%	-30.1%
2009-2012	18.7%	-0.3%	-8.1%	1.0%
2013-2016	10.0%			
Mean	1.4%	-0.7%	2.8%	3.6%
Median	4.0%	-0.3%	2.3%	3.8%
Geo Mean	0.8%	-2.0%	2.1%	3.0%
Std Dev.	10.6%	16.4%	12.6%	11.2%
C.V (SD/Mean)	7.4	(21.9)	4.5	3.1
Pct Positive	65%	48%	67%	76%

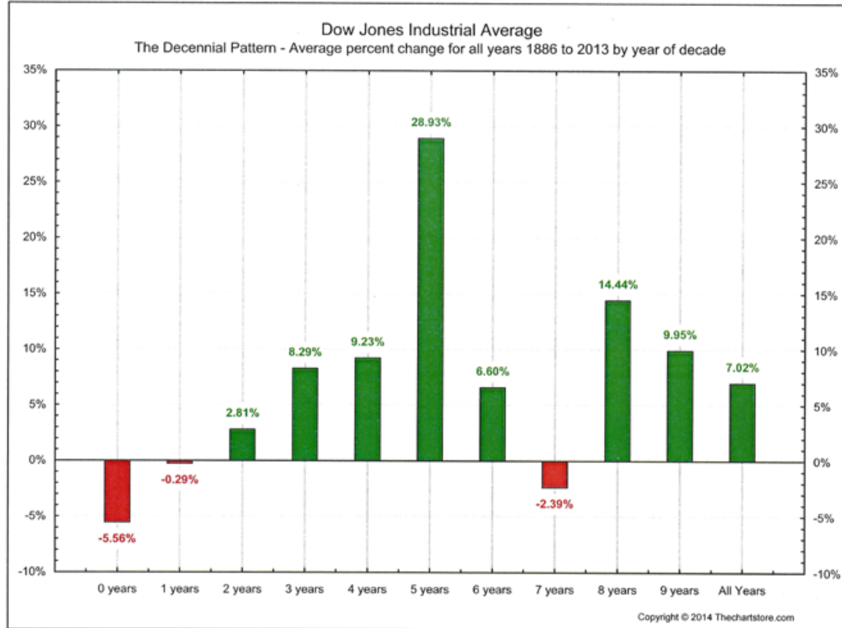
S&P 500 Price only since 1930
Source - Haysadvisory.com & Mark Dodson, CFA (@MarkTDodson)

Table 2 – The Presidential Cycle Sweet Spot
Election Cycle & November-April Returns

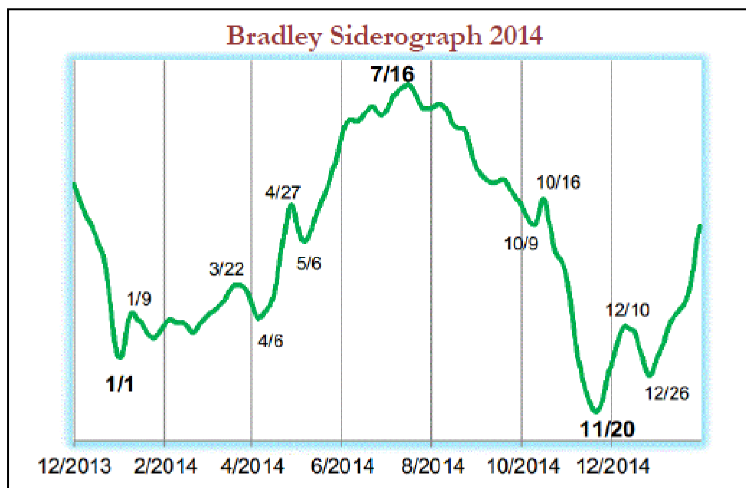
Period	Post-Election Yr 1	Mid Term Yr 2	Pre-Election Yr 3	Election Yr 4
1929-1932		-10.9%	-44.6%	19.5%
1933-1936	16.7%	5.3%	10.5%	-4.5%
1937-1940	-21.5%	-17.1%	-5.0%	-16.0%
1941-1944	-19.4%	23.0%	-0.4%	16.1%
1945-1948	12.7%	-1.8%	0.3%	-10.9%
1949-1952	12.7%	14.8%	1.7%	0.4%
1953-1956	15.2%	19.8%	14.3%	0.4%
1957-1960	5.8%	12.2%	-5.5%	22.3%
1961-1964	-4.9%	23.5%	7.4%	5.0%
1965-1968	-1.5%	17.2%	4.5%	0.3%
1969-1972	-16.1%	24.9%	14.3%	-4.1%
1973-1976	-16.6%	18.1%	14.2%	-4.3%
1977-1980	4.9%	9.2%	4.4%	4.2%
1981-1984	-4.5%	23.0%	-2.1%	8.3%
1985-1988	24.1%	18.2%	3.8%	11.0%
1989-1992	-2.8%	23.5%	5.7%	5.1%
1993-1996	-3.6%	9.0%	12.5%	13.6%
1997-2000	21.6%	21.5%	6.6%	-12.6%
2001-2004	1.6%	3.5%	5.4%	2.4%
2005-2008	8.6%	7.6%	-10.6%	-9.9%
2009-2012	14.5%	15.2%	11.5%	13.1%
2013-2016	7.3%			
Mean	2.6%	12.4%	2.3%	2.8%
Median	4.9%	15.2%	4.5%	2.4%
Geo Mean	1.7%	11.8%	1.3%	2.3%
Std Dev.	13.4%	11.5%	12.8%	10.7%
C.V (SD/Mean)	5.1	0.9	5.5	3.8
Pct Positive	57%	86%	71%	67%

S&P 500 Price only since 1930
Source - Haysadvisory.com & Mark Dodson, CFA

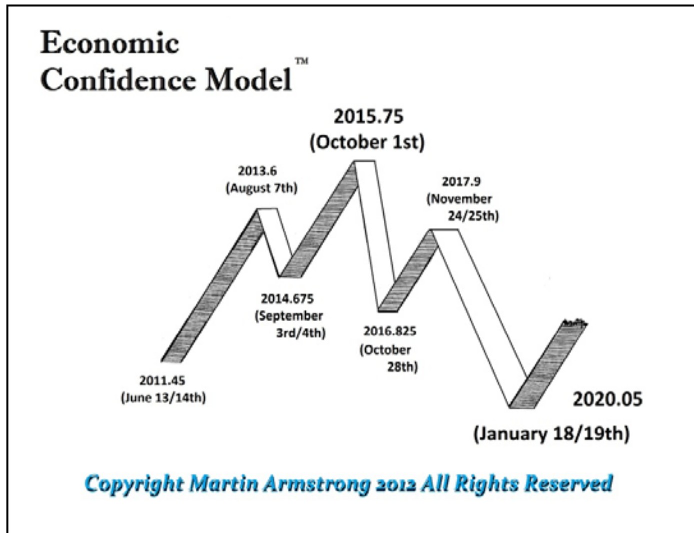
The market has been fueled by an accommodating Fed policy resulting in low interest rates. We really don't know what the catalyst will be to prompt the midterm market correction which we are anticipating. We review the charts of all of our holdings weekly and others as well and we see few tops and find others which we don't own which have developing consolidations which are usually a prelude to higher prices. The Advance-Decline Line has continued to make new highs, and now the NYSE Composite Index has finally made a new high. The CBOE Volatility Index (VIX), a key measure of market expectation is very low at just over 11, similar to the levels of 2005 to 2007. This signals complacency and little concern about a market decline. Ironically, this is the time that we should be concerned, as when so few are concerned, contrary opinion is on the side of a market decline.



Dr. Hyman Minsky long ago pointed out that stability leads to instability; in other words, that the more comfortable we get with a certain condition or trend the longer it will persist and then when the trend fails, which it ultimately must, then the more dramatic the correction will be. We are all too aware of the lingering Ukrainian situation, the ISIS gallop across Iraq and now the Israeli/Palestinian confrontation, each of which has the potential for a war which could bring our involvement despite our hesitancy. So far the market has ignored this, but that can change quickly. Shown here is the Bradley Siderograph which was in our January letter, but we think is worth another look. The turning points are based on astrological measurements, and are often very prescient; other times it has been wrong. However, for what it is worth, it has been very accurate so far this year, including the dips, and is peaking in mid-July. The bottom it predicts this November is the culmination of the 40.22-month cycle multiplied by 3, or just over 10 years.



Also shown here is the Armstrong Economic Confidence Model, which bottoms in early September and then rises for over a year to October 2015. This model is not necessarily a stock market predictive tool, but rather a measure of economic confidence which certainly can influence the stock market. However, his model has predicted many stock market turning points, such as the 1987 crash—almost to the day. Our readers will remember Martin Armstrong from past letters, as he served the longest sentence in history (7 years) for contempt of court when he would not produce certain assets, which he could not because he was never in possession of them. His measurements are all based on his discovery of an 8.6-year cycle which has its mathematical support in the fact that the number of days in 8.6 years is 3,141 or 3.14159 (Pi) times 1000.

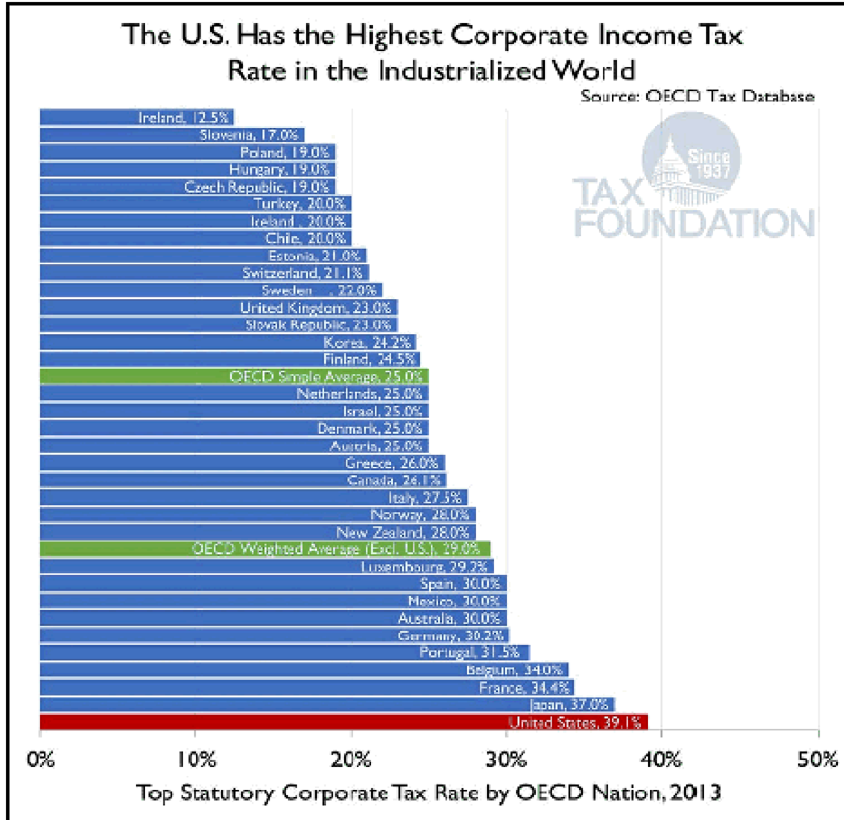


We noted earlier that there has always been a 5th-year rise—until there wasn't, in 2005, despite our assertion that there would be one. Likewise, there has always been a midterm correction, several less than 10%, in 2006 (-8% in June), 1994 (-9.7% in April), and 1986 (-8.6% in September) although most are from 20% to 40%. It is conceivable that the 7.4% February decline could pass for the midterm decline. It is unlikely, but possible. Gerald Loeb said years ago that after he found the key to the market, they changed the lock. We know "the market" has a way of ruining the best laid plans, so we do admit the anticipated midyear decline either may not happen or has happened. We live in a market of stocks and not a stock market. Our client portfolios have some liquidity, and we sell when we see a chart top or a fundamental reason to sell. Meanwhile, we maintain the course—for who knows—the 5th-year rise may already be underway.

THE TAX AVOIDANCE SHUFFLE

A June announcement from Medtronic, one of the jewels among the companies located in Minnesota, took many shareholders by surprise when they learned that the proposed acquisition of Covidien, a medical company with its tax headquarters in Ireland, but its operating headquarters in Massachusetts, was just that—an acquisition—not a merger, but a taxable one. Medtronic and many other companies make acquisitions frequently, and Medtronic has made many of them over the years. Nothing unusual about a company acquiring another or combining with another through a merger process, which is typically tax-free to the shareholders. This acquisition of Covidien is a $42.9 billion transaction at $93.22 per Covidien share payable in cash of $35.19 and $53.03 in stock. Again, nothing unusual here, except that Covidien is now domiciled in Ireland for tax purposes, and since the company being acquired is in a country other than the U.S., the tax headquarters can

be moved to the acquired company's tax headquarters, in this case Dublin, and the company's operations in America can remain where they are. So while labeled as an acquisition, which it clearly is, there will be an exchange of both Covidien and Medtronic stock for shares of a new company called Medtronic PLC. This process, called an "inversion," has been used by many other American companies. The end result of an inversion is the saving of taxes which can be achieved. Immediately, the $14 billion cash which Medtronic has chosen to leave overseas rather than to send back to the U.S. to be taxed will be used to grow the business. We need to note that the U.S. tax rate is about 3 times that of Ireland at 39.1% versus 12.5% as can be seen in the table. Medtronic, however, would also pay the 9.8% Minnesota tax, making a total of nearly 50%, or 4 times the 12.5% after the merger. Therefore, as with other inversions, and there have been about a dozen in the past several years, the tax benefit is the reason. Recently, Pfizer has been trying to buy AstraZeneca, an English drug company, and Walgreens wants to buy Alliance Boots, a UK company based in Switzerland, and AbbVie has been pursuing Shire, an Irish drug company. Two other prominent Minnesota companies have moved their tax headquarters overseas to save taxes. In 2012 Pentair merged with Tyco Flow Control and moved its tax headquarters to Switzerland where Tyco had moved (from New Hampshire to Bermuda in 1997, then to Switzerland in 2009), and finally to Ireland this May when the Swiss introduced new rules on executive pay (interestingly, Covidien was once a division of Tyco International). Also, in late 2012, Stratasys, the Minnesota 3D printing company, moved its tax headquarters to Israel through the acquisition of Objet, an Israeli company. Stratasys will remain in Minnesota, as will Pentair. The Pentair inversion was not taxable to shareholders, however, because it was accomplished through a "Reverse Morris Trust" while the Stratasys inversion was taxable like the Medtronic deal. Clearly, there is an immediate advantage to an acquisition of a company in a country with a lower tax rate, thus using the cash trapped overseas from previous earnings. And, there will be a lower tax rate on all future earnings now that the company has its tax headquarters abroad.



This all sounds great at first blush, and maybe it is in terms of creating long-term value, but it gives many Medtronic shareholders apoplexy in the form of a large tax bite, because the exchange of Medtronic shares for new Medtronic PLC shares is a taxable event. This is especially hard for Minnesota shareholders as Minnesota does not distinguish between long-term and short-term gains and, worse, all capital gains are the same as ordinary income for tax purposes. Therefore, a Minnesota resident could pay as much as 30% in combined federal and state tax on this exchange. The biggest impact, of course, will be on those with the lowest cost. Remember, Medtronic was formed here in Minnesota over 60 years ago and has a large number of long-term Minnesota shareholders, with an extremely low cost, certainly below $5 per share and perhaps even below $1 per share. And that is why many Minnesotans are unhappy being forced, in effect, to sell when the exchange is made, and getting no cash to pay the taxes.

An article in the Sunday, July 6, *StarTribune* estimated the tax at $212,000 for a holder with 10,000 shares at a pre-split cost of $1 per share. A real life example was also included—a man who bought 25 shares in 1968 and wound up with 12,800 shares after all the splits; his financial advisor estimates his tax bill at $274,000! Adding insult to injury, the company is picking up part of the tax bill for executives and directors as it is paying the excise tax payable on stock compensation. They still must pay the tax on their stock gains. Note that the excise tax was initiated in 2004 by Congress as a disincentive for companies shifting taxes to overseas via inversions. True to form, companies countered by paying the tax for executives.

Bill George, former chairman and CEO of Medtronic, writing on the subject in the June 29 *Star Tribune* on the Viewpoint page, insists that despite the tax consequence, this is a deal to benefit all shareholders over the long-term as the two companies fit together perfectly, and will have significant cash flow to grow the business, which it would not otherwise have, and therefore, presumably can be larger and more profitable for the benefit of all shareholders, present and future. There are shareholders, of course, that do not pay taxes on stock transactions, such as IRAs, foundations, pension, and profit sharing plans. So clearly, they will benefit both now and in the long-term future. Here at PCM, Medtronic is held in some accounts, as was Covidien, so we have sold the Covidien at a nice profit and continue to hold Medtronic and presumably will continue to hold the new Medtronic PLC. The accounts that held Covidien also own Medtronic so at least the after-tax profit on Covidien will more than pay the tax on the Medtronic transaction. These were our larger accounts for which we use large growing companies as well as smaller, but still growing companies, which are widely held in all accounts. While a temporary unhappiness for certain Medtronic shareholders, the benefit of the acquisition will make Medtronic more attractive as a long-term holding. And so, in this case maybe two plus two does equal more than four. Time will tell.

Until Congress lowers the corporate tax rate, there will be more inversion acquisitions by major US companies with substantial overseas earnings that have not been repatriated, because if they were, they would be taxed at what is almost a confiscatory rate. And so, they leave these funds overseas, rather than paying tax, leaving little choice than trying to find an international company in a country with a favorable tax rate. A corporate tax

holiday is needed to get these funds repatriated. As it turns out, even without doing an inversion acquisition many US corporations pay a very low tax rate or in some cases none at all due to a variety of special breaks and tax loopholes. A subject for another time.

THE CLOSING THOUGHT

Veterans Day, Memorial Day and Independence Day have come and gone. In lieu of a cartoon, we have a picture taken at the Fort Snelling National Cemetery in Minneapolis and published in the Star Tribune titled “Standing Guard.” It is real and not a Photoshop enhancement and was taken by an amateur photographer, Frank Glick. There are many bald eagles in the vicinity of the cemetery, which is not far from the Mississippi River where there are many eagle nests. Regardless, it sends a message. The eagle is standing guard over those who died to defend our freedoms. Unfortunately, we continue to see our freedoms eroded, not only by wars, but by government policies. We recommend the new documentary movie by Dinesh D’Souza, *America: Imagine the World Without Her*.

Sincerely,

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