

October 16, 2015

Dear PCM Clients and Friends:

It is a well known joke that Minnesota has two seasons—winter and road repair. But this year it is no joke, there is serious road repair with obligatory detours, traffic slowdowns and the usual result—unhappy drivers, who should really be happy that when finished, traffic will move faster and more safely. At least we will be able to reach our destination, as more than once we have turned down a meeting because “we can’t get there from here.”

But road repair season will soon be over, except for some major projects, which will continue year-round, such as making a four-lane highway into six lanes from 394 east of Wayzata to the 494-694 interchange some 8.5 miles north. This is an \$86 million dollar project (\$10 million per mile), which is scheduled to take two years. So when the road repair season ends, the autumn season begins, which brings the hunting season

(shooting, if you are English or Scottish). And if it is deer you are hunting in the UK, it is called stalking. But first is the bird shooting season, duck, pheasant, grouse, woodcock, and then comes deer stalking. And it gives us an opportunity to enjoy the fall colors on the trees by the roadsides and in the forest, from brilliant red to traffic cone orange.



We also look forward to fall mushroom hunting season—oops—mushroom foraging season. While spring brings the morel in its various strains of the species, which is the best known and most widely sought; there are other spring mushrooms that are ignored. Fall mushrooms are numerous and varied, with the puffball the best known, but least tasty. Others, such as the hen of the woods (as shown in the picture) and the chanterelle are just as easily

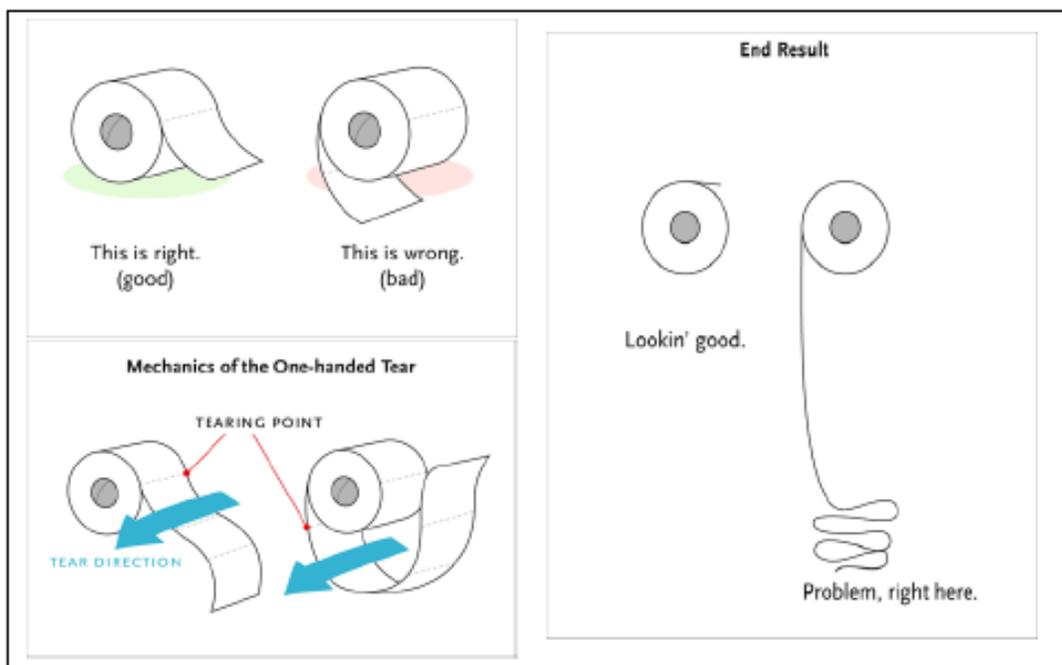
recognizable as the morel in the spring, and like the morel, they each have their distinctive flavor.

So, as we leave the road repair season, we move into autumn, our favorite part of the year, with its leaves turning color, waterfowl and bird shooting, deer stalking and mushroom foraging. It does not get better than that!

A MESSAGE FROM PERK

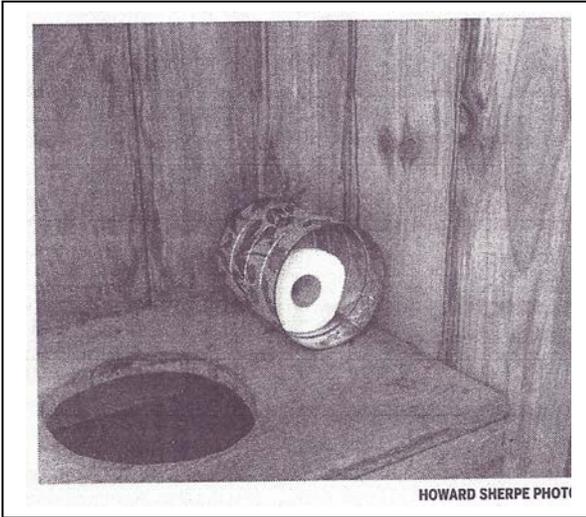
There are many things in our lives where there is more than one point of view. For example, many of us would prefer different political candidates, or have a differing opinion on a TV show, a movie or an automobile design. However, there is nothing quite as black or white as the ideal way to hang toilet paper, i.e., over and not under. In your household, as in mine, there are probably two points of view. One is that it doesn't matter, so why fret about it; the other is that there is only one way to put the roll on and that is over. If I find that it is under, I simply change it to over without any comment; who needs an argument over toilet paper? Same at the office. After all, there are some things where there is only one sensible, correct answer.

The correct and incorrect ways are shown in the illustration, with the end result of improper installation resulting in excess paper on the floor:



According to Wikipedia, each average American uses 49 rolls of TP a year, 49,000 sheets, unless you are Sheryl Crow who has proposed that to save trees we should use only one sheet per bathroom visit. You see, she puts it over, not under, to save TP. Back in my youth, I spent most of the summer on the farm where my mother grew up. My dearly beloved Aunt Hilma lived there with my mother's twin brother, Harry. The farm didn't get electricity until some years after Franklin Delano Roosevelt, as part of the New Deal, got the country out of the Great Depression by authorizing the REA (Rural Electrification Agency) to help farmers get on their feet by giving them aid to get electricity. I don't know the year that the farm got electricity, but I know that some years later they made room for an indoor flushing toilet. I suppose I was in my teens by then, so in earlier years it was the outhouse, meaning not only outside the house, but as far "out" as possible. We may have very well had a TP holder screwed to the wall, but I don't remember it. I do remember

keeping the roll in a coffee can, as shown in the photo.



I should explain that Howard Sherpe, who was given credit for the photo, has written a weekly column for my hometown newspaper, The Westby Times, titled “Across The Fence” for many years. One of his columns which I have saved is titled, “Over or Under,” where he discusses the subject that we are spending time on here. This particular column reminded me that in the first years of my farm visits there was no TP—just pages from a Sears catalog. Yes, Hilma and Harry were what could be called poor—as they farmed only 120 acres to feed a small herd of a dozen or so cows for milk that was picked up daily by a truck, which took it to the local dairy. The monthly milk check provided the daily

living money, in addition to selling chickens and eggs. The money for an auto upgrade, for example, or probably the refrigerator when electricity came, or some other necessity came once a year from the tobacco check as four or five acres were given up to raising tobacco. Yes, Vernon County, WI, was famous for the tobacco it grew which was used as cigar wrapping. But that story is for another time. I have digressed too far from the toilet paper subject. So back then the worry was not over or under, but just inside a can to keep it dry or better yet, with the coffee can over it to keep the bugs and spiders away. Such were the days back then--something that I appreciate being a part of 75 years ago.

THE MARKET SCOREBOARD

What can we say—the stock market was down, and the 3rd quarter results contributed mightily to poor year-to-date numbers. One glance at the table shows that in the quarter small-cap stocks suffered the most. The Russell 2000 was off nearly 12%, with the S&P Small-Cap down 9% plus. This was, accordingly, not a good quarter for PCM accounts. More on that in the section “That 1000 Point Drop: What’s Next?”

Ranked by Q3 Return Indexes	% Return Q3 2015
Russell 1000 Total Return	-6.83
S&P 500 Composite Total Return	-6.94
Russell 3000 Total Return	-7.25
NASDAQ Composite	-7.35
Dow Jones Industrial Average	-7.58
Wilshire 5000	-7.89
S&P Small-Cap 600 Total Return	-9.27
NYSE Composite	-9.31
Value Line Composite	-11.27
Russell 2000 Total Return	-11.92

Ranked by YTD Return Indexes	% Return YTD 2015
NASDAQ Composite	-2.45
Russell 1000 Total Return	-5.24
Russell 3000 Total Return	-5.45
S&P Small-Cap 600 Total Return	-5.49
S&P 500 Composite Total Return	-6.75
Wilshire 5000	-7.16
Russell 2000 Total Return	-7.73
Dow Jones Industrial Average	-8.63
NYSE Composite	-9.59
Value Line Composite	-9.93

THAT 1000 POINT DROP: WHAT HAPPENED?

In a word, electronic trading in a new world of algorithms. In days long ago and now forgotten, the specialist on the NYSE made sure there was an orderly opening, matching buyers and sellers, or if an orderly opening was not possible, messaging a likely opening price range. But that time is gone. Welcome to electronic trading, where sellers can overwhelm buyers, if in fact there are any; or vice versa, of course. In high frequency trading there are many different algorithms that are competing with each other from different sources. On August 24, there were multiple algorithms that decided to sell various asset classes, from stocks to ETFs, which in turn triggered other algorithms resulting in a cascading waterfall decline. There was no human intervention as there would have been in earlier years. But what was the event that persuaded so many algorithms to sell? Likely, it was a belated recognition of events in China in the previous several months, which began on June 12 with a decline on the Shanghai Stock Exchange; and by July 9 the Shanghai Stock Market had fallen 30% over three weeks and 1400 companies had filed for a trading halt. In addition, the China Securities Regulating Commission imposed a six-month ban on stockholders owning more than 5% of a company's stock from selling, which helped, resulting in about a 6% rise in Chinese markets. In China about 80% of investors are individuals who had fueled the rise, pledging their houses or other assets as collateral for loans to play the market. But on August 11, the Peoples Bank of China devalued the renminbi by nearly 2%, and then on August 14 devalued it again. On August 24, the Shanghai Index lost 8.5% and here in the U.S. in the week prior, the Dow Jones had fallen over concerns about the Yuan and the effect of China's losses on world markets. Then on August 24, the Dow dropped 1000 points on the opening in a belated recognition of the Chinese market declines.

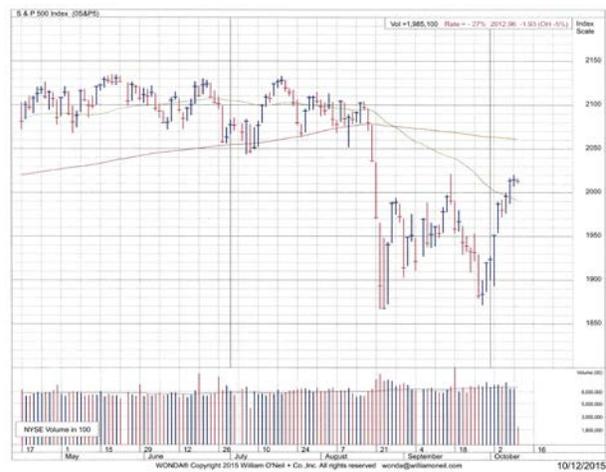
As we noted earlier; our computerized electronic market could literally not cope with an "all sellers and no buyers" situation. The stabilization of the NYSE specialist was gone, and Dodd-Frank had killed the traditional risk taking market makers and big trading desks. The repeal of the uptick rule in 2007 made it even worse. The resulting meltdown was great for some and a debacle for others; someone sold GE at \$20 during the opening. The stock had closed on Friday at \$24.57 and got as low as \$19.37 before closing at \$23.87. Oops! Some unhappy sellers and some lucky buyers. But perhaps the worst punishment was for the ETFs, which could not keep the prices of the ETF up to the price implied by the component stocks, resulting in extreme mispricing. An illustration was the iShares Select Dividend ETF (DVY) which dropped more than the value of its component shares; 15 minutes after the opening on August 24 it traded down 35% to \$48, while at that time the combined weighted value of the component securities was actually \$72.42. Ouch! So much for the attractiveness of ETFs, which unlike mutual funds that are priced only at the end of a day, ETFs can be traded at any time during the market day. Almost certainly, the August 24 "crash" will result in SEC investigations, comment periods and no action.

This volatility has jumped significantly in the month of September when 80% or more of the S&P 500's stocks moved in the same direction each day—up or down. This volatility is new, and attributable to electronic trading which is of recent origin and will only get worse unless the SEC finds a way to deal with it, which in our view is unlikely as money talks.

THAT 1000 POINT DROP: WHAT'S NEXT

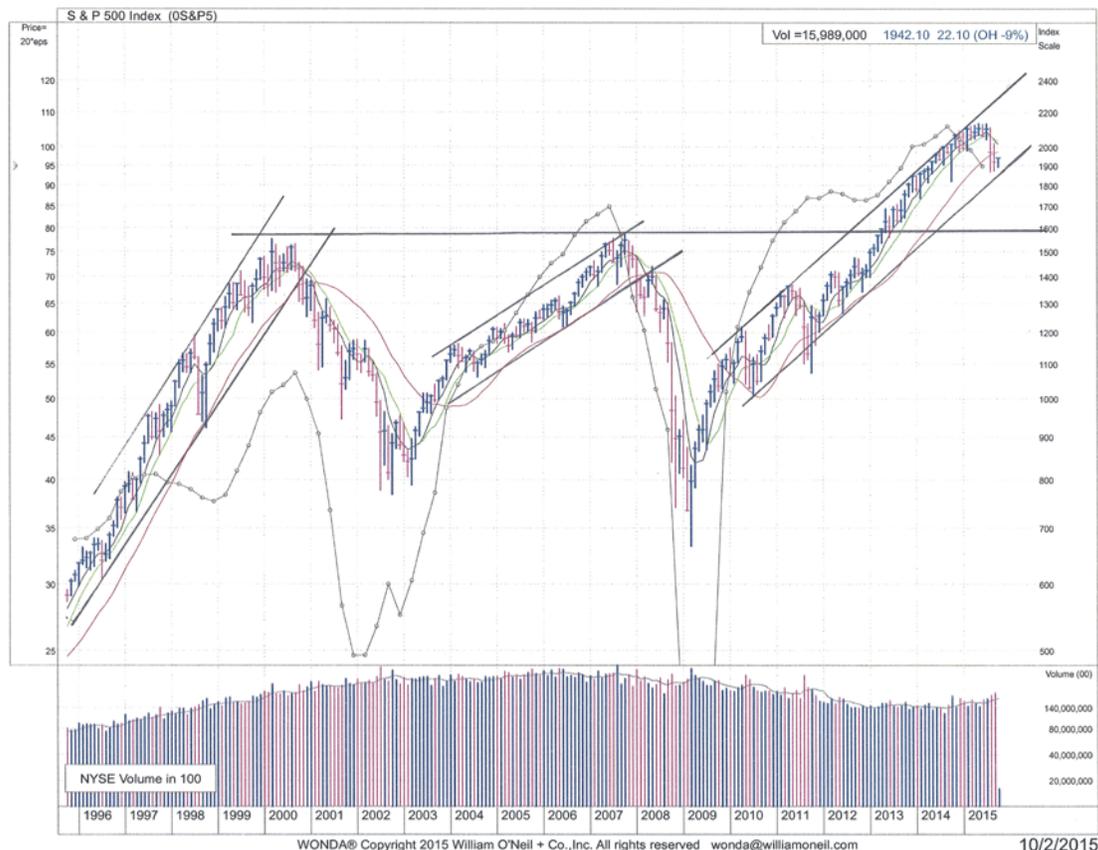
The August 24 decline was in a way a “wake up call” as the market had presumably become overvalued, and needed a correction to regain its footing. While October has a reputation of being a bad month, because of market bottoms as in 1987, September has historically been the weakest month of the year. This year was no exception, as the August 24 carnage continued for most of September, culminating in a disastrous day on Thursday, September 24, when the Obama administration’s \$3.55 trillion budget plan for 2016 was announced, which included cuts to Medicare, and private health insurance plans serving seniors, who would take the biggest hit. PCM accounts have been heavily invested in healthcare—specifically drug and medical device companies which has given us good performance until September with most of the damage the last week in September. This resulted in declines of individual stocks ranging from 11% to 35%. The largest were in Rockwell Medical at -36%, Cardiovascular Systems at -34%, and Depomed at -30%. This hurt, as Cardiovascular Systems is our 4th largest position, although our largest holding, St. Jude Medical, was off only -11% for September. A template of most PCM accounts showed a decline for the 3rd quarter of slightly over 9%, in line with the S&P Small-Cap 600 Total Return of -9.27% as shown in the scoreboard on page three.

But September and the 3rd quarter are history—what about the immediate future? After a market “crash” there typically is a rally, which in the past two instances, in 1998 and 2011 lasted 17 days, then a decline back down to “test” the crash low, stopping at that level or slightly below, then gradually moving back up. In the 1998 instance, the market continued on up until mid 2000; in the 2011 example, it continued going up until the high this year. Charts of the crash history of 2011 and this year are shown below:



This year, so far, was similar to the rally off those crash lows, as shown in the chart. The initial rally lasted 17 days before the testing process started, which took the S&P 500 back to the crash low, but not through it. The ensuing rally was into its 4th day, on Friday, October 2, when the S&P gave us a classic “one-day reversal,” also called an outside day, when it was down some 50 points at the low, then turned and closed up 27 points. Likewise, the Dow Jones Industrial Average was down 260 points from the previous close, then turned around and closed up 200 points. This could mean that the low September 29

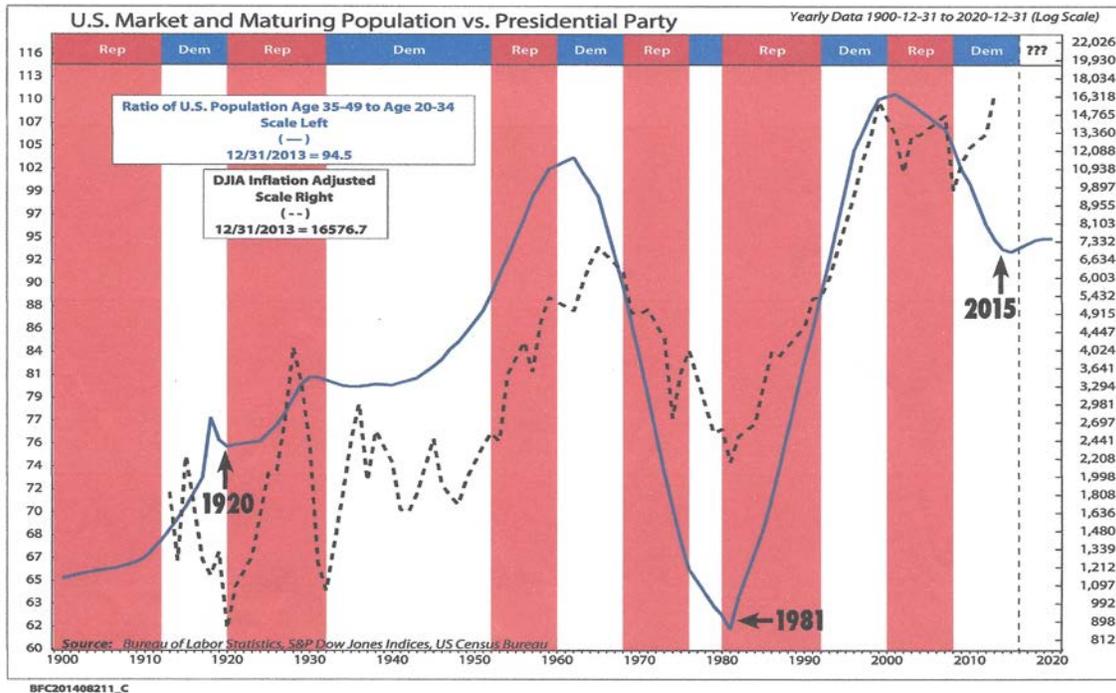
was the bottom of this correction. Of course, we won't know for sure until more time has passed, but this is the way it looks now. The big picture, however, shows (chart below) that the trend line from the 2010 low is still intact, except for the 2011 crash, and the short-term average (green line) has not yet broken through the long-term average (red line), which in the past has signaled the end of a market run. It looks ominous, but only time will tell. Major support, as you can see, is at 1600; let's hope we can avoid that level.



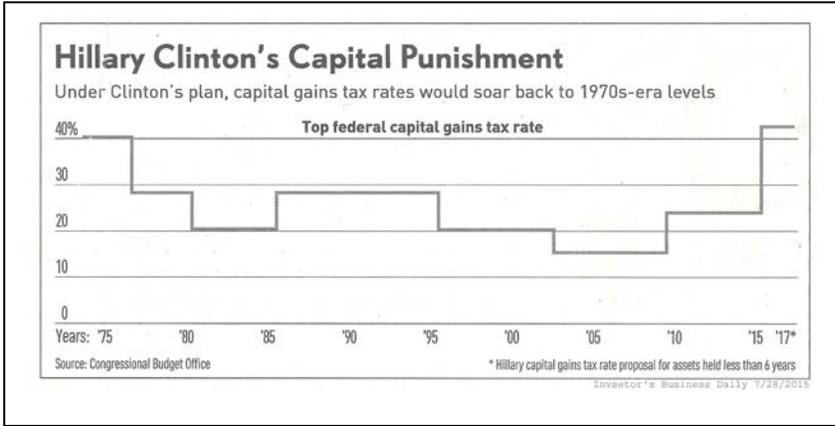
THE TORTOISE(S) AND THE HARE

Can it really be true that we have already suffered through several months of presidential politics, and it still isn't over yet, a year before the election? This pumping and stumping by a bevy of Republicans, and two (three with Biden) Democrats, battling to see who ultimately becomes that party's choice for president. The conventions for the final choices for each party are still months away, July 18-21, 2016 for the Republicans, and July 25-26, 2016 for the Democrats; then the game changes and we go through more months of the Republican candidate battling the Democratic candidate. Unless, of course, someone decides to run as an Independent. Wouldn't that be fun? Guess who? It is interesting to us that the three Republicans with the most poll points are not politicians—a billionaire businessman, a neurosurgeon, and a female ex-corporate executive. We think this tells us a lot about the mood of the American voter who is in effect saying they are sick and tired of

politicians and political favoritism. Fed up! When U.S. citizens are asked if the country is headed in the right direction 70% say no, and that is a big clue. In the past, this has resulted in "change" elections. We believe demographics show that it is about time for a change, as the Ned Davis graph dramatically shows. So the voters looking at the crop of



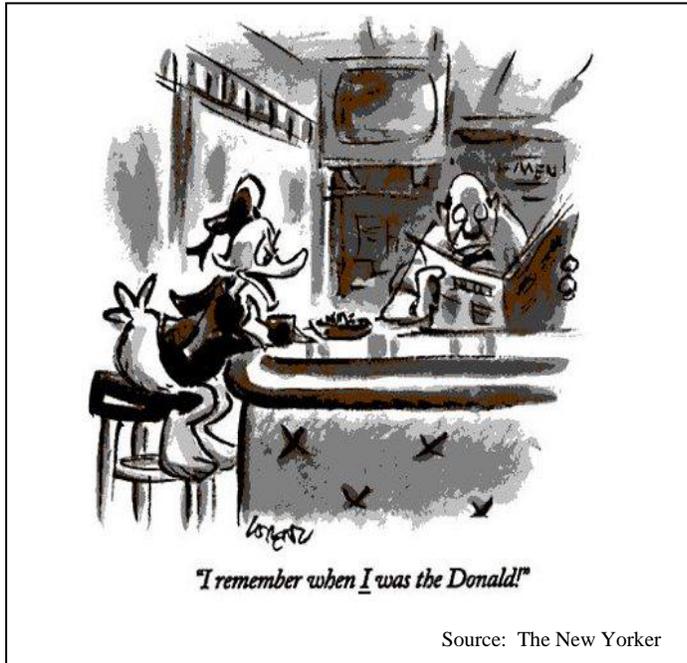
Republican hopefuls are opting for candidates out of the mainstream, in other words, no more politicians. As we write this, there is Trump, Carson and Fiorina, in that order. The Democrats are stuck with Clinton and Sanders. And some Democrat party leaders are frightened at the thought of Sanders, while at the same time are beginning to realize that Hillary cannot win if nominated, and they will likely soon call in the cavalry by the name of Joe Biden. Hillary has shot herself in the foot so many times, that we are amazed she can still walk. Not just the lies about the emails, but the actual idea that she could get away with this in the first place. And her tax proposal went over like a lead balloon, even with democrats. But, Hillary may have met her match in something called The Freedom of Information



Act, passed back in 1966. In March a conservative organization, Citizens United, filed a lawsuit under the FOIA demanding documents from her tenure as Secretary of State relating to the Clinton Foundation, the 2012 Benghazi debacle in Libya and all other

messages regarding her position as Secretary of State. Finally released under FOIA, there was a treasure trove of previously unknown, unreleased emails. And there are more coming as there are still pending 35 FOIA lawsuits for Clinton-related emails which virtually guarantees an endless stream of bad news for Hillary. We will see what the Justice Department does about all of this, and since it is probably nothing, then we rely on the FBI. The cartoon at the end of our letter tells that story.

On the Republican side, Donald Trump, likened to Harold Hill in *The Music Man*, is on his bombastic soap box, and like Harold Hill, thinks he can say anything and get away with it.



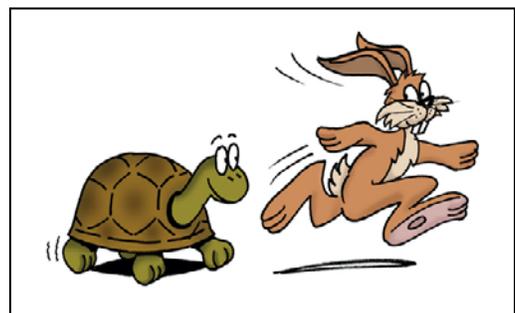
To many of us in Minnesota, Trump is a reincarnation of Jesse Ventura, who became governor of Minnesota in the November 1998 election. Ventura was a former Navy SEAL, and professional wrestler (The Body), who ran a bombastic and populist campaign by attacking career politicians. True, he ran as an independent and his republican competition, Minneapolis Mayor Coleman was weak, as was Minnesota Attorney General, Hubert H. "Skip" Humphrey III, running as a democrat. Minnesotans, like Americans today, were disenchanted with the political establishment and looking for a change. Ventura stumped in Minnesota's heartland traveling via bus and speaking countless times. In a

Tom Brokaw interview back then, he said his victory was a clarion call for the political establishment to quit their partisan party politicking and look after the people's business. Sound familiar?

The Body in 1998; the Donald in 2016. In contrast, Mr. Congeniality, Ben Carson, is the opposite—soft spoken, except when he talks about his ability "to remove a few brains in Washington," which he is literally capable of doing.

And then the Lady Fiorina, coming up in the polls, despite criticism of her Hewlett Packard management fiasco. However, as the New Yorker said recently, "Only in this country, perhaps, could a C.E.O. receive compensation worth more than a hundred million dollars in six years, get fired, and use the money to enter politics."

Yes, the tortoise(s) and the hare. It is time to relate the story we have used in a previous letter. This is it: Back in the Middle Ages one of the king's stable boys



was faced with death as punishment for the small crime of stealing an apple. As he heard his sentence from the king, and was asked if he had anything to say, he said, "Please, sire, if you will spare my life within a year, I shall teach your horse to talk." "Very well," said the king, "one year." When asked later why he would offer to do something that was impossible, he said "Yes, but many things could happen in a year; the king could die, the horse could die."

And so, in the Republican contest, which tortoise will beat the hare? Maybe none; a year will tell. And Hillary? See our cartoon at the end of the letter.

Sincerely,

R W Perkins

Richard W. Perkins, C.F.A.
President
Senior Portfolio Manager

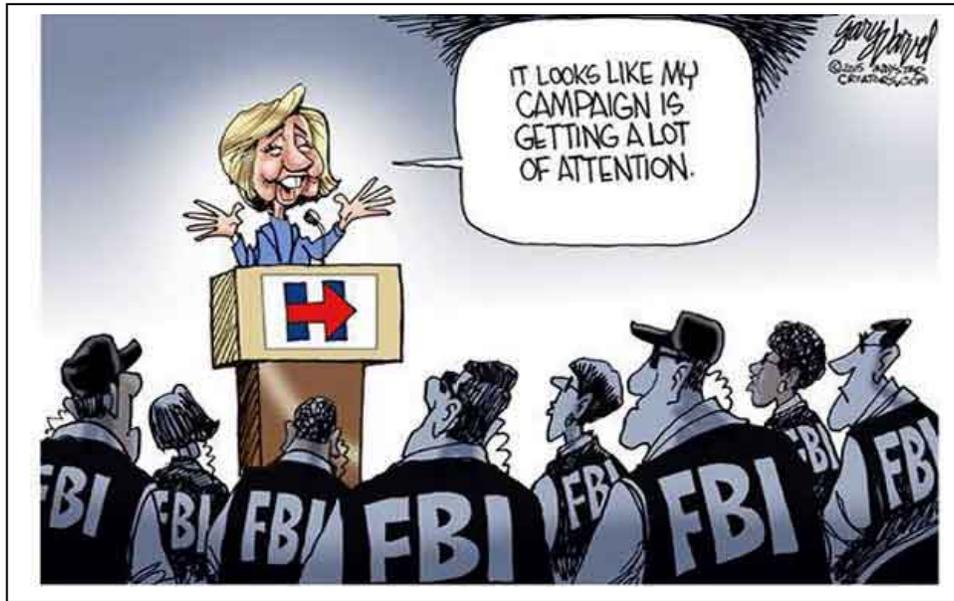
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Portfolio Manager

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JOKE PAGES FOLLOW →

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THE POPE IN NEW YORK

Pope Francis goes to New York. He is picked up at the airport by a limousine. He looks at the beautiful car and says to the driver, "You know, I hardly ever get to drive. Would you please let me?" The driver is understandably hesitant and says, "I'm sorry, but I don't think I'm supposed to do that." But the pope persists, "Please?"

The driver finally lets up. "Oh, all right, I can't really say no to the pope." So the pope takes the wheel, and boy, is he a speed demon! He hits the gas and goes around 100 mph in a 45 zone. A policeman notices and pulls him over. The cop walks up and asks the pope to roll down the window. Startled and surprised, the young officer asks the pope to wait a minute. He goes back to his patrol car and radios the chief.

Cop: "Chief, I have a problem." Chief: "What sort of problem?" Cop: "Well, you see, I pulled over this guy for driving way over the speed limit but it's someone really important." Chief: "Important like the mayor?" Cop: "No, no, much more important than that." Chief: "Important like the governor?" Cop: "Wayyyyyy more important than that." Chief: "Like the president?" Cop: "More." Chief: "Who's more important than the president?"

Cop: "I don't know, but he's got the pope driving for him!"

LOOSE LIVING

"A drunk that smelled like a brewery got on a bus one day. He sat down next to a priest. The drunk's shirt was stained, his face was full of bright red lipstick and he had a half-empty bottle of wine sticking out of his pocket. He opened his newspaper and started reading. A couple minutes later, he asked the priest, "Father, what causes arthritis?" "Mister, it's caused by loose living, being with cheap, wicked women, too much alcohol, and contempt for your fellow man," the priest replied.

"Imagine that," the drunk muttered. He returned to reading his paper. The priest, thinking about what he had said, turned to the man and apologized: "I'm sorry, I didn't mean to come on so strong. How long have you had arthritis?"

"I don't have arthritis, Father," the drunk said, "but I just read in the paper that the Pope does."

Winston Churchill loved paraprosdokians - figures of speech in which the latter part of a sentence or phrase is surprising or unexpected.

Where there's a will, I want to be in it.

Since light travels faster than sound, some people appear bright until you hear them speak.

If I agreed with you, we'd both be wrong.

War does not determine who is right - only who is left.

Knowledge is knowing a tomato is a fruit. Wisdom is not putting it in a fruit salad.

They begin the evening news with "Good Evening," then proceed to tell you why it isn't.

To steal ideas from one person is plagiarism. To steal from many is research.

In filling out an application, where it says, "In case of emergency, notify:" I always put "Doctor."

I didn't say it was your fault, I said I was blaming you.

Behind every successful man is his woman. Behind the fall of a successful man is usually another woman.

A clear conscience is the sign of a fuzzy memory.

You do not need a parachute to skydive. You only need a parachute to skydive twice.

Money can't buy happiness, but it sure makes misery easier to live with.

There's a fine line between cuddling and holding someone down so they can't get away.

I used to be indecisive. Now I'm not so sure.

You're never too old to learn something stupid.

Change is inevitable, except from a vending machine.

THE TAXI DRIVER

A passenger in a taxi heading for Midway airport leaned over to ask the driver a question and gently tapped him on the shoulder to get his attention. The driver screamed, lost control of the cab, nearly hit a bus, drove up over the curb and stopped just inches from a large plate window. For a few moments everything was silent in the cab. Then, the shaking driver said, "Are you ok? I'm so sorry, but you scared the daylights out of me."

The badly shaken passenger apologized to the driver and said, "I didn't realize that a mere tap on the shoulder would startle someone so badly." The driver replied, "No, no, I'm the one who is sorry, it's entirely my fault. Today is my very first day driving a cab. I've been driving a hearse for 25 years."

THE PRIEST AND THE RABBI

A priest and a rabbi were sitting next to each other on an airplane. After a while, the priest turned to the rabbi and asked, "Is it still a requirement of your faith that you not eat pork?" The rabbi responded, "Yes, that is still one of our laws."

The priest then asked, "Have you ever eaten pork?" To which the rabbi replied, "Yes, on one occasion I did succumb to temptation and tasted a ham sandwich." The priest nodded in understanding and went on with his reading.

A while later, the rabbi spoke up and asked the priest, "Father, is it still a requirement of your church that you remain celibate?" The priest replied, "Yes, that is still very much a part of our faith." The rabbi then asked him, "Father, have you ever fallen to the temptations of the flesh?" The priest replied, "Yes, rabbi, on one occasion I was weak and broke my faith."

The rabbi nodded understandingly and remained silent, and sat thinking, for about five minutes. Finally, the rabbi said, "Sure beats a ham sandwich, doesn't it?"

WOMEN'S REVENGE

"Cash, check or charge?" I asked, after folding items the woman wished to purchase. As she fumbled for her wallet, I noticed a remote control for a television set in her purse. "So, do you always carry your TV remote?" I asked. "No," she replied, "but my husband refused to come shopping with me, and I figured this was the most evil thing I could do to him legally."

WIFE VS. HUSBAND

A couple drove down a country road for several miles, not saying a word. An earlier discussion had led to an argument and neither of them wanted to concede their position. As they passed a barnyard of mules, goats, and pigs, the husband asked sarcastically, "Relatives of yours?" "Yep," the wife replied, "in-laws."

WORDS

A husband read an article to his wife about how many words women use a day 30,000 to a man's 15,000. The wife replied, "The reason has to be because we have to repeat everything to men." The husband then turned to his wife and asked, "What?"

BEWARE OF DOG

As the stranger enters a country store, he spots a sign: "Danger! Beware of Dog!" Inside, he sees a harmless old hound asleep in the middle of the floor. "Is that the dog we're supposed to beware of?" he asks the owner. "That's him," comes the reply.

"He doesn't look dangerous to me. Why would you post that sign?" "Before I posted that sign, people kept tripping over him."

CIRCLE FLIES

A cowboy from Texas attended a social function where Barack Obama was trying to gather support for his Health Plan. When Obama discovered the cowboy was from President Bush's home area, he started to belittle him by talking in a southern drawl and single syllable words. As he was doing that, he kept swatting at some flies that were buzzing around his head. The cowboy says, "Y'all havin' some problem with them circle flies?" Obama stopped talking and said, "Well, yes, if that's what they're called, but I've never heard of circle flies."

"Well, sir," the cowboy replies, "Circle flies hang around ranches. They're called circle flies because they're almost always found circling around the back end of a horse."

"Oh," Obama replies as he goes back to rambling.

But, a moment later he stops and bluntly asks, "Are you calling me a horse's ass?" "No, sir," the cowboy replies, "I have too much respect for the citizens of this country to call their president a horse's ass." "That's a good thing," Obama responds and begins rambling on once more. After a long pause, the cowboy, in his best Texas drawl says, "Hard to fool them circle flies, though."