

Highlights

- ◆ Top-Down Approach
- ◆ Look at Long Term Forward Trends
- ◆ Look for investment classes that benefit from trend

A Logical Approach to Portfolio Construction

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If you are like most people, the architects of your portfolio have been ad hoc, chance and spur-of-the-moment. We see portfolios all the time from investors that have no idea why they have the investments that are in their portfolio. It was what was available, a friend said to do it or I didn't know what else to do are common responses.

Cornerstone takes a different approach in building a portfolio. Our perspective is Top-down, which means we look at the overall economic conditions and markets first, and pick the actual investments last.

With all of the different investment options available today – Large Cap, foreign debt, emerging markets, junk bonds, small cap... the list goes on – how does an investor make a decision about where to invest? There are so many options, it gets confusing.

We start simply, by asking ourselves questions. We build the portfolio by first looking at long term trends, then intermediate trends and last short term.

What are the overall long term trends?

The US stock market – With the potential for earnings disappointments and a slowing economy, the long term trend (several years) for the stock market is down. It will likely be held back by the still unfolding housing collapse, a retreat of consumers and rising unemployment. This should impact earnings negatively and send the market to levels not seen in a decade.

Strategy – Avoid US equities, sell into rallies. Invest in “bear market” funds or market

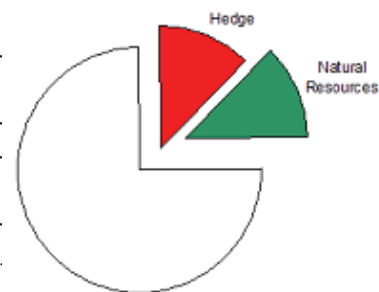
hedges, such as several of the ETFs available that invest in the short side. This gives us our first piece of the asset allocation pie: Market Hedges

Inflation – What is the current environment? Are prices for goods and services rising or falling? This can be confusing sometimes because both can be happening at once. On the one hand, the cost of raw materials and labor costs are rising for the major auto manufacturers, but at the same time, foreign competition is forcing prices to the consumer down, squeezing the profits of the car manufacturer.

Inflation in raw materials is a function of foreign consumption. This is a trend that is not likely to slow down any time soon. They have tasted capitalism and they like it. Millions of people will be migrating from rural areas in the 3rd world to more urban areas and along with that comes an almost geometric increase in the consumption of raw materials.

Strategy – The obvious answer is commodities and natural resources companies, especially oil. At various times the shift within the sector will go from food to base metals to industrial materials to oil and so on. But in general, this group has the biggest bullish push on it of any sector, with an expected bull market run that could last years if not decades. Investing in natural resources, commodities and raw material companies is the next piece of the pie.

Lower interest rates – This is an interesting one. Lower short term interest rates does not mean lower long term interest rates. In fact,



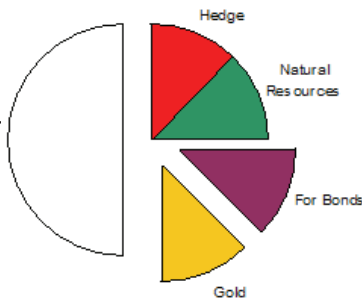
As Seen in

Forbes

Cornerstone

Investment Services has been chosen by Goldline Research as one of the Ten Most Dependable Wealth Managers of the NorthEast

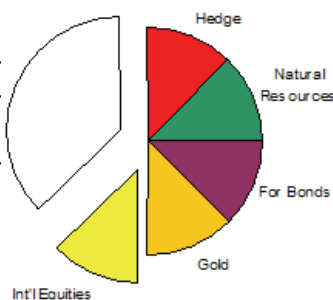
low short term interest rates does not mean a healthy economy. Interest rates in the 1930's were at or near zero and the economy was still depressed. In Japan for the past 15 years, they have been going through a deflationary funk that interest rates at zero percent could not fix.



Why are low interest rates likely not to help the economy? Because of too much debt. Almost every sector of the economy, from the government to the consumer is loaded down with record debt levels.

Strategy - As the Fed cranks up the presses to print more Dollars, the US Dollar is diluted and devalued. The best way to hedge the declining Dollar is to own the opposite asset. Foreign Debt and Gold.

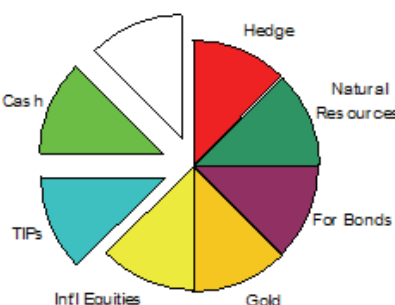
Growing Trade Deficit - With the potential for declining earnings domestically and the continual growth of the trade deficit, foreign companies may pick up the slack for growth. Opportunities may be presenting themselves for foreign companies to do more business with each other as America's share of the Global GDP continues to shrink.



Strategy - Owning International Equities may be a better source of equity growth compared to US stocks for the next several years.

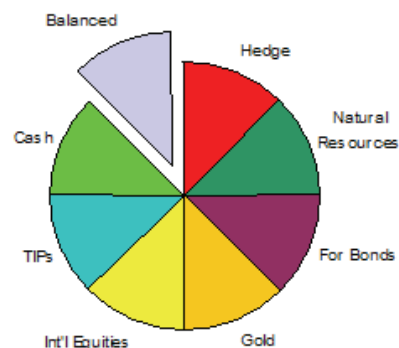
Geo-Political Tensions - With the world the way it is today, war in the Middle East, hot spots in Asia and growing tensions in South America, a surprise, war or terrorism should be expected.

Strategy - Have some assets as a safe haven is important. Cash is king for this



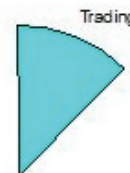
when it comes to principal safety and Treasuries are a place money runs to when there is global trouble. Since we are concerned with inflation, TIPS (Treasury Inflation Protection Securities) fill the bill here.

Momentum - The boys on Wall Street still control the game. They have defied the odds for years. The market should have had a correction years ago. The rally within a bear market that started in 2003 has gone on for much longer than most expected.



Strategy - Humility is important. No matter how right the evidence and statistics are, momentum can still carry the market higher in the face of terrible news. Having a balanced fund in the portfolio gives the investor a piece of what the boys on Wall street are doing.

Market Rallies - Regardless of the market conditions, even in the worst bear markets, there are always rallies. And many of them are tradable rallies. In most cases, investors should sell into rallies. But once the asset allocation is set, investors can take advantage of the rallies.



Strategy - Be prepared to trade. Not day trade, but take advantage of mis-priced securities, whatever they may be, whether they are stocks, bonds or whatever.

Allocation

Now that we have the assets picked, next is the allocation part. This is determined by how much risk the investor is willing to accept and how much of an impact the asset class is likely to have.

We are constantly adjusting the allocation of the portfolio to take advantage of the shifting sands of the market place and economy. We look at intermediate and short term trends when adjusting our allocation.

What are the intermediate trends? These could be an acceleration of the long term trend or counter trends to the long term. If an asset class

has gone too far too fast, we may reduce our allocation in anticipation of a pullback. For instance, if oil were to race up to 120/bbl in the next 2 weeks based on tensions in the Middle East, we would be ready to cut our Natural Resources allocation. We would then increase it after a significant pullback.

Short term opportunities could include trades and taking advantage of anticipated news. If it were expected that more banks were going to report huge losses due to sub-prime, we might increase our hedges specifically in the financial area. Or if some bad news came out for a stock that had been a consistent performer, and the stock dropped quickly, we might use that as an opportunity to trade.

Our strategy is fully flexible. In other words, if it appeared that the US market had become a good value again, we would adjust our asset allocation to include that asset class. We are not locked into a certain pre-determined minimum or maximum percentage on any asset class.

Our Asset Allocation is also not static. It needs constant monitoring and adjusting. In the current and foreseeable market and economic conditions, the old buy n' hold mentality of the 90's will not work.

If this logical approach to portfolio construction is something you agree with, then Cornerstone's money management may be for you. Contact our office or your local Cornerstone rep for more information on how you too can have this kind of investment strategy.

Questions, comments, further information, to set up an appointment or request forms, call: Toll Free:
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