CORNERSTONE
INVESTMENT SERVICES, LLC

# Cornerstone Commentary

## Key Points

- Investing 101, Buy & Hold, etc are dead
- Investing 201 will be like an advanced investing class
- Self Control and Patience will be keys to success
- Markets will need to be traded

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**Forbes**

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

# Investing 201

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## Investing 101

From 1982 through 2000, whether they knew it or not, investors were enrolled in a class called Investing 101. The rules were simple and easy to understand. Buy and hold; markets always go up; every dip is a buying opportunity; indexing; you can do it yourself; age-based asset allocation; and so on.

Thanks to flawed theories like MPT (Modern Portfolio Theory) and KISS (Keep It Simple Stupid) investors were told they could easily get in on the riches that awaited them. All they had to do was jump into the market with both feet. And don't forget about your 401k!

Investing 101 ended in the first quarter of 2000, but few investors realized it. They continued to do things the same old way, expecting the old rules to apply. But they didn't. They survived the 2000-2002 bear market and were relieved by the resurgent market from 2002- 2007. They didn't realize they were in for a brutal test.

## Tough Entrance Exam

The 3rd quarter of 2008 was the entrance exam for the next class the market is teaching - **Investing 201**. If they hadn't learned them in the previous few years, investors learned a few new lessons the hard way: Gone are the days of buy and hold. Markets don't always go up. Declines are not always buying opportunities. Age based asset allocation is foolish and many investors are waking up to the realization that they can't do it themselves.

Welcome to 2009 and beyond. Welcome to Investing 201. It is an advanced class. If Investing 101 was Kindergarten, Investing 201 is College. This is investing for adults. It is not for the faint of heart. It is not for those that think the difference between a stock and a bond fund is the color of the brochure.

## Class Begins Today

Like it or not, if you have any investments, stocks, bonds, mutual funds, or a 401k, you have enrolled in Investing 201. And it is a killer of a class. The teacher doesn't give anybody a break and you get penalized big for any errors. To be successful in Investing 201, the first thing you need to do is throw out the old rulebook. Investing 101 is over, the advanced class has begun.

## If You Can't Take It, Drop Out Now

If you can't or won't do the things mentioned in this report, drop out of the class. Get out now, because it isn't going to get any easier. Sit in bank CDs and suffer the consequences of a "risk-free" life. Ignore that you are being ravaged by inflation. Forget that you are now tied to interest rates. Turn a blind eye to the continuing problems in the banking industry.

## Brand New Curriculum

The lessons that will be taught in Investing 201 will include:

- Self Control: Panicking is not a strategy
- Patience: The age of instant gratification is over
- Trading: When to buy and sell
- Beyond Stocks & Bonds: Alternative Investments
- Value Investing
- Market Cycles and how they affect asset allocation
- How to profit from a market decline
- The difference between a bull market and a bear market rally
- And most importantly, the cost of good advice is minimal when compared to the potential losses from not having it.

Failing any one of these lessons can mean failure of your entire investment strategy.

## Self Control

*"Can't you understand what's happening here? Don't you see what's happening? Potter isn't selling. Potter's buying! And why? Because we're panicky and he's not. That's why. He's picking up some bargains. Now, we can get through this thing all right. We've got to stick together, though. We've got to have faith in each other." - George Bailey "It's a Wonderful Life"*

Many times, investors are their own worst enemy. Emotions, rather than logic and reason, determine their strategy. They get greedy and buy when things are too expensive. They panic when the markets decline and sell out at the wrong time.

Investing 201 will be a test of self control. Investors with a clear strategy and understanding of what to expect are more likely to succeed than those that panic and sell out without understanding the potential for profits.

We are going to get through this thing alright, but not if investors panic. We at Cornerstone are not panicking, we are looking to pick up some bargains.

## Patience

*"...Take during the depression, for instance. You and I were the only ones that kept our heads." – Old Man*

## Key Points

- What others call Alternative Investments we call Essential
- When did water become an alternative to Coke?
- Trading will take more patience
- Good traders take losses

*Potter speaking to George Bailey– It's a Wonderful Life*

What is unsaid in that scene from the movie is that it was some time before Potter and George made money from their investments. They knew that the things they bought cheap would be worth more in the future.

Potter and Bailey both knew what it took to pass Investing 201 and they had the patience to wait for their investments to mature and give them the profits they knew were there.

Impatient investors will fail Investing 201. The get rich quick days are over and now fundamental investing is taking its place. It is like the tortoise and the hare and you know who wins.

### Trading

Talk to many investors and they will tell you they never trade or won't trade or think there is something wrong with trading. (We are not talking about day-traders, the people that sit in front of their computer screens thinking they have it all figured out with their "can't miss" strategies.) Like it or not, the probability is that the next few years are probably going to be choppy. Those willing to trade will be able to exploit the potential for profit.

Trading means three things to us. First, some investments need to be sold at some point. They can get overvalued. (This doesn't mean that you try to get out at the top. This is a foolish and risky strategy. The more overvalued an investment becomes, the more risk it has.) It is about the potential risk versus the potential reward.

The second is a targeted strategy. It is buying XYZ today, because fundamentals research shows the potential future value is a certain amount higher. How much? Enough to offset the potential downside risks.

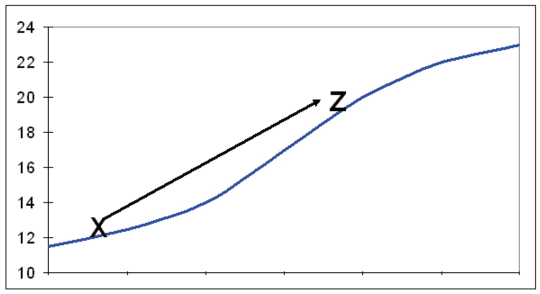
Do we wait to sell at the target? Maybe. Constant re-evaluation must go on to fine tune the target. As circumstances change, the potential for hitting the target become better or worse. Sometimes the target will be moved up, sometimes, it will be reduced. Short term share price movements may be irrelevant to this strategy, unless it impacts the potential to hit the target.

The third is short term technical trading. This is based on events, news or technical analysis of the price movements of the investment's chart. It may be as short as a day or as long as a few months.

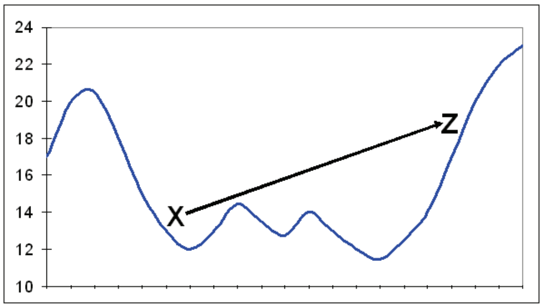
In many cases, our methodology encompasses several strategies at the same time. We may have a short term trade planned with a specific target, based on future news or fundamentals. We may have a long term trade planned, and bump the target price up as circumstances improve.

We may sell part of a core holding for no other reason than it has become too high an allocation within

**Target Trading**




Simply, target trading is buying at point X and selling at point Z. But it isn't as simple as it looks above.




This is more likely a scenario. Buy at X and watch the market go up and down for while. But if an investor is truly a long term investor and not a short term stock jockey, and the research is good and your conclusions are correct, then even if it goes to new lows as in the example above, the investor should not panic or get concerned. The era of instant gratification is over.

the portfolio. This would mean that it has performed well and the discipline of reducing the allocation forces us to sell when the asset is up. With any strategy, you need to be willing to take losses. Circumstances change, selling waves hit, any number of variables can change to force the liquidation of a losing position. The reason for selling a losing position is usually to stop the loss from getting worse.

### When did water become an alternative to Coke?

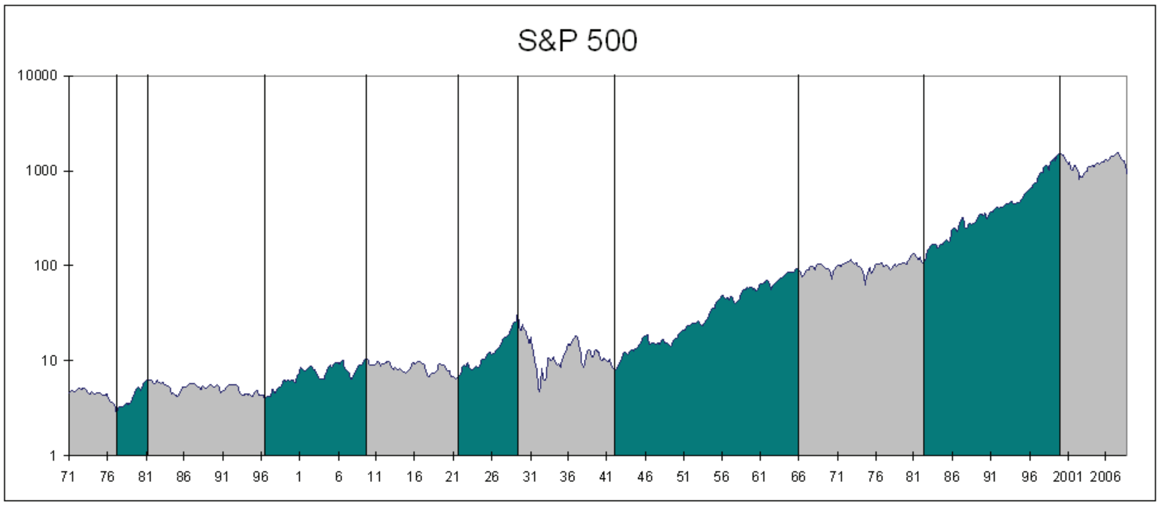
What many refer to as "Alternative Investments" we refer to as essential. Our investing world has gotten itself so cock-eyed and turned around, that water is referred to as an "Alternative Investment" and Coca-Cola is a core holding. Huh? I don't know anyone that needs to have a Coke everyday to survive, but I'm pretty sure water is a necessity. Ask the people in nations around the world suffering from droughts if they need Coke or clean water to grow their crops.

The US Government tells us that the Inflation Rate is so and so, but the "Core Inflation" rate, doesn't include food and energy. What? It doesn't include food and energy? I guess that is because they are unnecessary and an extravagance. Really? Who can live without food and energy?

Energy is also considered an Alternative Investment. It seems to those on Wall Street, heating your homes and getting to work are luxuries meant only for a select few.

## Key Points

- Secular Bear Markets can last years
- Cycles determine asset allocation
- In the past 137 years, there was a secular bull market only 47% of the time
- Expect bear market rallies, but a new bull will be years away




Other alternative investments include short strategies such as bear market funds and ETFs. Apparently bear markets aren't mainstream! Yet we seem to have them often enough. The chart on the next page shows that there has been a secular bear market over 53% of the time since 1871.

Who came up with these definitions? Who decides what is and what isn't an "Alternative Investment?" It is Wall Street.

### Working for themselves, not you

Wall Street's number one client is not the investor with the biggest account. That person is their biggest mark. Their most important client is an investment banking client - Somebody that is bringing a big bond deal or stock deal to them. Investors are Wall Street's ready market to whom they sell their latest bond offering or secondary stock deal or a new issue of preferreds.

Since Wall Street doesn't deal with oil or gold or cattle directly, they have no reason to push them as investment options to their clients. This makes them "Alternative Investments" to Wall Street because it isn't the main thing they are pushing, which are stocks and bonds.

Bear market funds and short strategies are also "Alternative Investments" to Wall Street since they make their bread and butter telling investors that stocks always go up. Telling investors that the market is overvalued and they should get defensive would be counter-productive and work against their primary income generator, the issuance of new stocks and bonds. If investors aren't buying new issues, the investment banking side of the business, their cash cow, dries up.

### Value investing doesn't mean a low priced stock

Many investors are under the delusion that a low priced stock is a good value and a high priced stock is expensive. Price has nothing to do with the value of the stock except as it relates to the underlying fundamentals like earnings and dividends. A $100 stock could be cheap if its EPS growth rate is above 15% and its P/E ratio is under 10x. Likewise, a $10 stock could be expensive or overvalued if it is trading with a P/E of over 25 and the EPS growth rate is about 5%. Earnings growth rates are important and how they relate to the P/E multiple can tell an investor much about the stock's value.

Notice I didn't say company. We are talking about stocks. Wall Street strategists and brokers like to say, "I buy companies, not stocks." Well that is a lie. They buy stocks. And this bologna that Wall Street encourages is dangerous.

The company can be wonderful and still have an overpriced stock. Just because a company is a good company doesn't justify overpaying for the stock. The upcoming market cycle will likely beat that into investors.

### Know the Cycle or have it run you over

We have written several articles about market cycles, (Long Term Cycles, Age Based Asset Allocation) suffice to say, if you don't understand where in the cycle you are, you won't be able to allocate your assets properly. Mr. Market doesn't care how old you are or how much money you have. The cycle is going to happen with or without you. Just because you are retired doesn't mean you should automatically own bonds. Just because you have a long time until retirement doesn't necessarily mean you should invest in stocks.

The cycle dictates the asset allocation and those that don't follow this will likely suffer for it.

### Get Comfortable, the bear is going to be around for a while

As the chart above shows, bear market s can last years, one was over 16 years. Since 1871, the average secular bear market has lasted over 12 years. The last bear market in bonds lasted almost 40 years.

### New Bull or Bear Rally?

We expect this bear market in US equities to last longer than the average because of the size of the economic problems going into the bear. It is going to take years, maybe decades to work off the debt load built up in the past 10 – 15 years. We will not have a

## Strategy

- Many investors will need professional help
- Markets have gotten more confused and difficult
- Old strategies are dead
- Successful investors will employ new strategies

real bull market develop until debt levels are less than half of today's and pricing power returns to most industries.

But that doesn't mean we won't have rallies. We are probably going to have a bunch of bear market rallies that will suck investors in and then wham! The bear comes back. The chart above shows that the bear markets were not straight down. Each bear gave plenty of opportunities for investors to lose more money by jumping in on the rallies.

### You need professional help

Bear market rallies… Interest rates going up… The Dollar collapsing… oil depletion… gold as a hedge… short ETFs… It is an awful, confusing and scary world for most investors.

It is a wonderful and exciting environment for those that understand how to take advantage of the market volatility, bear markets and relentlessly negative headlines.

Let's face it, Investing 201 is not for most investors. You probably should have gotten out years ago when things started to get ugly, but you were too busy or you didn't know what to do. The market doesn't care about your schedule or your inexperience or that you need this money for your retirement.

This is where a professional comes in. Most investors cannot do it on their own anymore. Sure, any dolt can buy a stock on E*Trade, their commercials even compare you to a monkey or a baby spitting up on himself. Good for them. Not exactly whom I would pick to manage my finances during these difficult times, but…

Investing 101 is dead. Buy and Hold died with it and so did the painless, brainless method of investing that many subscribed to for so long. Now you need to be on top of things and understand why inflation could take off when the Fed lowers rates or why the Dollar could lose it's reserve currency status and what it means to your investments or how to take advantage of the bear markets instead of being hurt by them.

Unfortunately, many investment professionals, brokers and advisors don't know how to handle the new environment. They have been brought up through the Wall Street system. They are still stuck on MPT and Buy & Hold and are looking for things to return to the way they were in the 1990's. They aren't equipped to handle Investing 201. They don't have the independence, research or experience to guide their clients through what will be difficult period for those not prepared properly.

At Cornerstone, we have been preparing for Investing 201 for years. We are ready for what the markets have for us and have a strategy that is flexible enough to take advantage of whatever the markets throw at us. The next few years are going to be like getting an advanced degree in investing – Investing 201. We are ready for it, are you?

**Questions, comments, further information, to set up an appointment or request forms, call: Toll Free: 1-888-277-5968**

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