CORNERSTONE
INVESTMENT SERVICES, LLC

Cornerstone Commentary

Key Points

- Market Hedges worked
- Client portfolios have low correlation to the Market
- Clients don't have exposure to US banks, brokerages, or insurance companies
- Clients don't have mortgage bonds or commercial paper
- Average client portfolio has over 50% of assets in Cash, Treasury TIPS and Market Hedges

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**

Where do we go from here?

John Riley
Chief Strategist
10/04/2008

The 3rd quarter of 2008 was the first time the Cornerstone Model showed a quarterly loss. The main culprit was the US Dollar's strength. It drove down oil, gold and international investments.

On the positive side, our hedges did their job, rallying as the market dropped, mitigating the losses.

How have hedges performed Year to Date?

Prudent Bear	23.01%
DXD	78.09%
SDS	91.02%
EFU	130.64%

Major Indices Year To Date:

S&P 500	-32.92%
Dow Jones Ind	-30.21%
NASDAQ	-34.39%

Source: Yahoo! Finance

Low Correlation, Low Impact
Because our client portfolios have a very low correlation with the market, the current bear market in stocks has had very little impact on client portfolios. At this point, the average client portfolio has over 50% of their assets in cash, Treasury TIPs and market hedges. Other than a small amount through the Balanced Fund, investor portfolios are not exposed to the S&P 500, banks, brokerages or insurance companies. We have no exposure to Commercial Paper or mortgages. It doesn't mean that our portfolios won't have volatility, but it is re-assuring to know it is not a direct result of the current US stock market panic.

Glass Half Empty, Glass Half Full?
I've never been either a glass half empty or glass half full kind of person. I just want to know how to fill it the rest of the way. To that end, I'm focused on where we go from here.

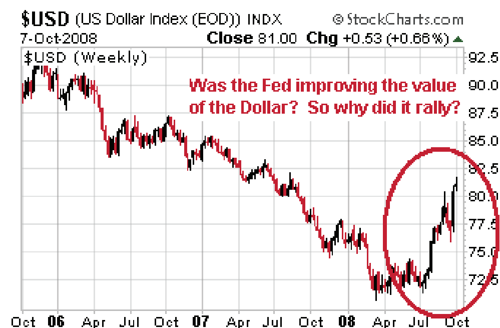
Abnormal Markets
You don't have to be told that the past three months or so have not been normal. The stock market has been in free fall, banks and brokerages folding and commodities correcting. This part was what we expected.

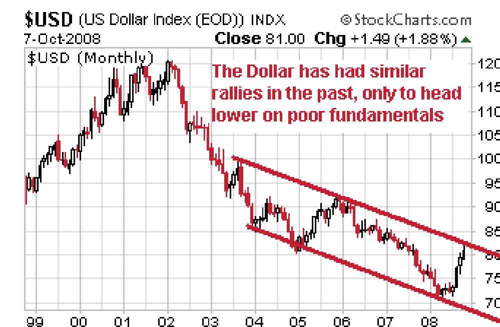
We've been preaching for years that the mountain of debt and derivatives would eventually bring down the stock market and various banks and brokerages. We've also expected a commodity correction. It is normal for commodities to have corrections of 30% or more during bull markets.

What was abnormal was the strength of the US Dollar and the unprecedented (*read illegal*) interventions and bailouts by the Fed. First, the Fed has never been authorized to buy company stock, guarantee loans between companies or manipulate markets. (*Creative reading of the Fed's job and some stretching of the meanings of words apparently authorizes them to do just about anything.*)

Everything that the Fed has done this year has weakened the Dollar so it should have continued its decline, and possibly even collapsed. Had this happened, our performance for the 3rd quarter would have been much different. Gold would not have declined as much, oil and other commodities would have had a correction and then a recovery. Foreign bonds would have hedged the declining Dollar.

But abnormal markets don't stay abnormal for long. Whatever has been driving the Dollar higher in the face of what the Fed has been doing to it will eventually subside and the Dollar should resume its march lower.





Key Points

- $2.42 Trillion Bailout
- Fed has eroded the value of the Dollar
- Printing presses are in high gear printing Dollars
- Throughout history countries have done the same thing and hyper-inflation usually followed

And what exactly has the Fed been doing to destroy the value of the Dollar?

~~$700 Billion Bailout~~

$2.42 Trillion **Bailout and counting...**

The Dollar had been declining because of massive debt growth and easy money policies. So, for it to rally, you would think the Bailout Plan would reduce debt, right? Since the beginning of the year, here's what the Fed has done:

$30 billion to JP Morgan to buy Bear Stearns
$300 billion in loans when they opened the discount window to brokerages
$300 billion to the Federal Housing Administration
$200 billion for Fannie Mae and Freddie Mac
$400 billion to bail out mortgage lenders and home-owners. (CIS research estimate)
$138 billion to JP Morgan for settling trades with Lehman Bros.
$85 billion to buy AIG
$38 billion loan to AIG
$50 billion for Money Market funds
$700 billion Bailout Bill
$150 billion in "sweeteners" to get the Bailout Bill to pass.
$25 billion loan to the autos

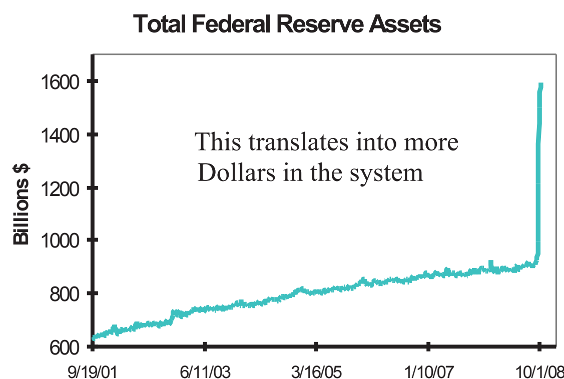
$2.42 TRILLION Dollars. So far. And that doesn't include the following:
$7 billion for California
$7 billion for Massachusetts
Unlimited line of credit for the FDIC

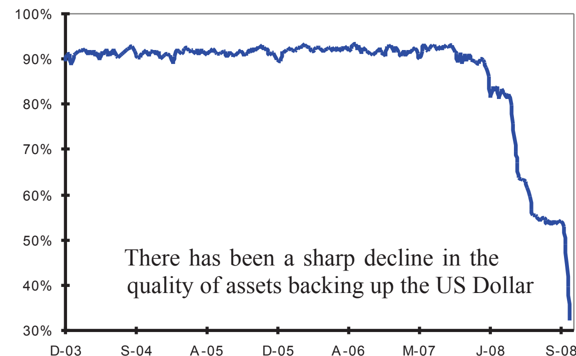
Oh yes, and I almost forgot, we doubled our national debt when **$5 trillion** was added to it thanks to the takeover of Fannie Mae and Freddie Mac.

That brings us to roughly **7.50 TRILLION** dollars of new deals and debt that we are responsible for. *No wonder the Dollar is rallying, the Fed has been acting so responsibly!*

It is obvious to anyone with an Omron calculator that the Fed has diluted the US Dollar and has put the currency on the brink of collapse and the economy flirting with hyper-inflation.

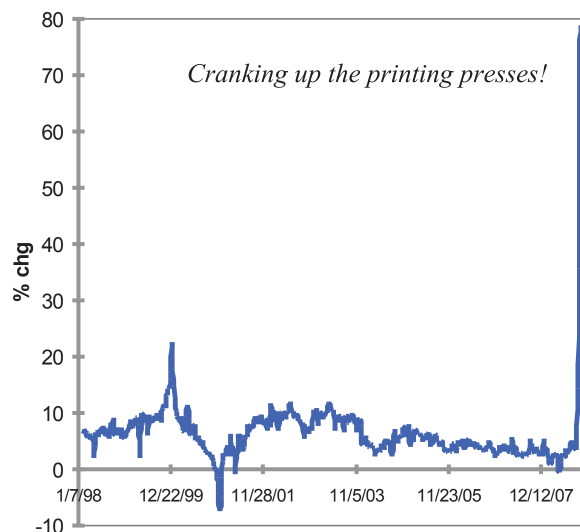
But they say a picture is worth a thousand words. So here is what the Fed has done to their own balance sheet. Remember, the Dollar in your pocket says "**Federal Reserve Note**"





Source: Federal Reserve; Inspiration: Chris Puplava, Puplava Securities; Format CIS

What this shows is that the Fed has been expanding it's own balance sheet by taking on poorer quality investments. At this point, about one third of the Fed's Assets are Treasuries. This is what is backing up the US Dollar, junk from banks and Wall Street.



Source: Federal Reserve; Inspiration: Chris Puplava, Puplava Securities; Format CIS

And at the same time, they have the printing presses humming, spitting out more and more Dollars, devaluing the ones you have in your pocket.

A Voice of Reason

On May 28, 2008, the Dallas Fed Governor, Richard Fisher, gave a speech to the Commonwealth Club of California about unfunded liabilities of the US Government. In it he said:

"Throughout history, many nations, when confronted by sizable debts they were unable or unwilling to repay, have seized upon an apparently painless solution to this dilemma: monetization. Just have the monetary authority run cash off the printing presses until the debt is repaid, the story goes, then promise to be responsible from that point on and hope your sins will be forgiven by God and Milton Friedman and everyone else.

We know from centuries of evidence in countless economies, from ancient Rome to today's Zimbabwe, that running the printing press to pay off today's bills leads to much worse problems later on. The inflation that

Key Points

- Short term strategy will be to maintain high cash positions in anticipation of opportunities
- Dollar weakness likely to bring Inflation
- Inflation benefits hard assets, gold and oil

results from the flood of money into the economy turns out to be far worse than the fiscal pain those countries hoped to avoid."

Richard Fisher is known as one of the inflation hawks on the Fed Board. He has been against rate cuts because of the damage it would do to the Dollar. As of the writing of this report, the markets are anticipating an emergency rate cut of 50 basis points, if not more. It would appear that Mr. Fisher is out-voted, but is a voice of reason that should be heeded.

The Course is Set

The Fed has cranked up the printing presses to keep the economy alive. They are frantically bailing out banks and brokerages in an effort to avoid an economic downturn. It is apparent that the Fed is monetizing the debt. This is very bad for the US Dollar. It is very bad for the economy. The inflation that will come with the falling Dollar will bring with it higher oil prices, natural resources and higher interest rates.

Investment Strategy – How we can benefit from the Fed's Folly

Knowing what the Fed is doing makes it clear that the Dollar's recent advance is nothing more than a bear market rally. When the manipulation that is driving the Dollar higher ends, the Dollar is likely to collapse, bringing with it even stronger inflation than had they left it alone.

This means oil and other natural resources should resume their bull markets. Foreign bonds should be a good hedge on the Dollar's decline. The biggest beneficiary of all should be gold. We have reduced allocations to these areas over the past few months, but will increase them as the Dollar resumes its decline.

The Fed seems to be trying to bail everybody out. Who will bail out the Fed? I'll opt for protection from the Fed's irresponsible actions by staying with the investments that should benefit most from their recklessness.

As always, we are focused on the future trends and are allocating assets accordingly. But we are not blind to the current crisis and will increase hedges and cash where appropriate to take advantage of the Fed's Folly.

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