CIS RISK REWARD GAUGE

Cornerstone Investment Services, LLC

"THOSE WHO CANNOT LEARN FROM HISTORY ARE DOOMED TO REPEAT IT."[a]

As the market barrels higher since the election, wouldn't it be nice to have some way of knowing if the market is a good buy or not? If you listen to the financial news, just keep putting money in the market, its going up forever!

Seems to me we've heard this before - in 2000 and in 2007. And how did they end? Not well. The 2000 to 2002 drop was about **44%** and the 2007 to 2009 drop was over **50%**.

At Cornerstone, we have developed a Risk/Reward Gauge that tells how much upside might be left in the market and how much risk is in the market.

The indicator uses a special PE ratio called the Cyclically Adjusted PE or CAPE. It takes a lot of the "noise" out of the market and shows a very clear valuation cycle.

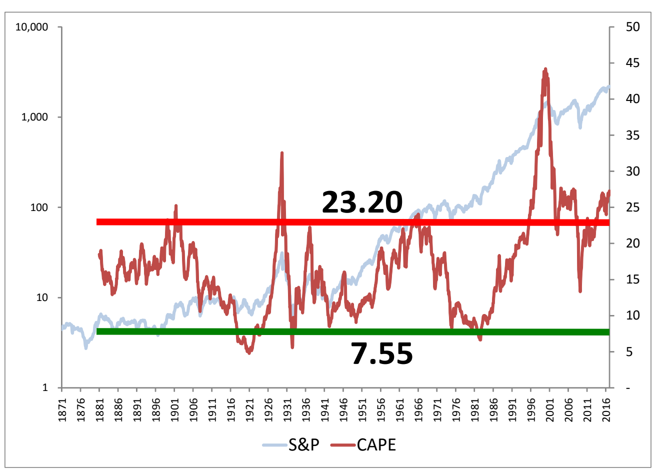
Since 1871, the chart to the right shows that market tends to top out when the CAPE averages[1] about 23.20 and bottoms out when the CAPE is about 7.55.

So there you have it, a very easy starting point to determine if the market is near a top or a bottom.

"The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell." - Sir John Templeton

Now comes the fun part, all the time in between! This is where our indicator helps out.

With this information, we were able to estimate the current market upside and risk.[2] On the next page is a chart with the Risk/Return listed for several points in recent history.



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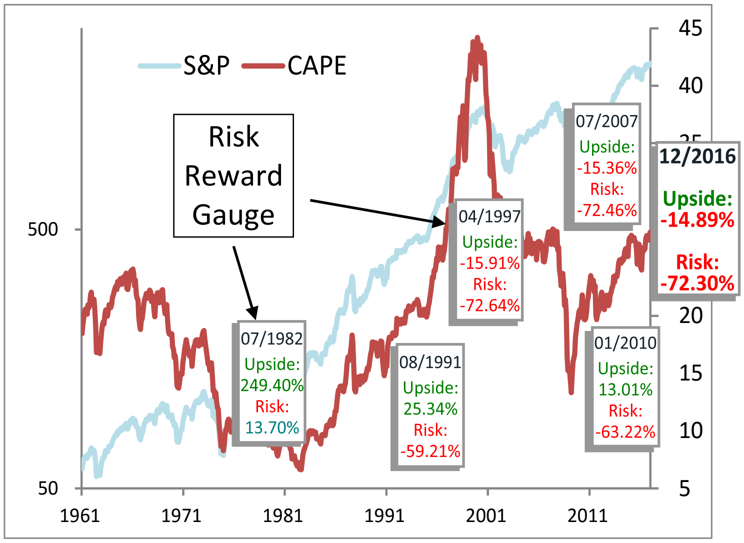
Looking at the chart, the lower the CAPE, the higher the upside and the lower the risk.

Here's the part many investors today do not get, (even seasoned professionals!) The higher the CAPE, the lower the upside and higher the risk.

Seems obvious, right?!

Look at some of the dates - July of 1982 was so undervalued that the Risk number was positive! And July 2007 was so overvalued that the upside was negative!

(The lawyers want me to remind you at this point that all investing has risks and that the upside and risk numbers are estimates and are not guarantees.)



IS THE UPSIDE WORTH THE RISK?

Is the potential return worth the risk? This is the question investors should be asking themselves, especially in the current environment.

Since January of 2010, the risks have far outweighed the potential upside of the market. Yet investors ignored the risks and drove the market well above its historical average CAPE. They said it was a new paradigm.

"The four most dangerous words in investing: 'this time it's different.'" - Sir John Templeton

HOW TO USE THE GAUGE

It is a good way to measure risks and returns based on historical data. If the Upside number has turned negative, this means the current CAPE is above the historical average and risks are very high, the market has become speculative. This doesn't mean the market cannot go higher, but for prudent investors, the game is over and it is time to get defensive.

Remember how crazy the market was in 2007? Everybody was piling in. And then it all fell apart. Today, everybody is tripping over themselves to get into one of the most overvalued markets in history.

Thanks to the Risk/Reward Gauge, you can see that today's CAPE is similar to 2007, with a negative upside and substantial risks. That is not to say the market can't rally further. It can. Irrational exuberance is back in full swing. And we know how that ended.

Or as Sir Isaac Newton said after losing his fortune in the South Sea Bubble - ***"I can calculate the motion of heavenly bodies, but not the madness of people."***

a - One of many variations attributed to George Santayana, Benjamin Graham and Winston Churchill.

1 - To calculate the average historical high and low valuations, we took the monthly peak or low CAPE number and averaged it with the previous 6 months and following 6 months. 13 months in all were averaged together for each peak and low. By doing this, we were able to eliminate any outliers that may have occurred, which could be misleading. This also gave us a better overvaluation and undervaluation number, since markets are not overvalued or undervalued at just one point in time. We then took theses results and averaged them together. This produced the numbers on the chart. We did not include the peak in 2000 or the low in 2009 since these are not within the normal cycle and the cycle has potentially not concluded.

2 - To calculate the upside and risk, we used the following formula: (ACAPE-CCAPE)/CCAPE; ACAPE = Average CAPE; CCAPE = Current CAPE

Charts - Source: Shiller; Format CIS

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