CIS | CORNERSTONE INVESTMENT SERVICES

Mid Year 2020

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This has been an extraordinary year to say the least! Things have happened that have never happened before, and are still happening. There was no playbook, no guide for what has happened medically, socially, politically, economically, and to the markets. Mis-information seems to be the guiding principal this year.

With that in mind, regarding our Model Portfolio and Tactical Strategy, I wanted to speak directly to you, about your concerns and where we at Cornerstone stand.

1 – What is our investing philosophy?

***Primum non nocere**:* First, do no harm (Merriam-Webster) This is one of the guiding principles in medical ethics. There are similar ethical standards for investment managers.

Prudent Man Rule: Prudent Man Rule is an investment standard. It directs trustees "*to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested*". [Harvard College v. Armory 9 Pick (26 Mass) 446, 461 1830] - Source: US Legal.com

Fiduciary: A fiduciary is a person or organization that acts on behalf of another person or persons to manage assets. Essentially, a fiduciary owes to that other entity the duties of good faith and trust. The highest legal duty of one party to another, being a fiduciary requires being bound ethically to act in the other's best interests. - Source: Investopedia

The Prudent Man Rule and the definition of a Fiduciary set the table on how an investment advisor is to act. This means putting the client first and not putting the client in potential unwarranted risk. It doesn't say to eliminate risk, but some interpretations have said to manage the risk.

But there have also been many wise guides along the way that have helped direct and mold our investment philosophy - Investors like Bob Farrell from Merrill Lynch, Jim Rogers from the Quantum Fund, Sir John Templeton, considered the Father of international investing and Benjamin Graham, considered the Father of value investing. Graham literally wrote the book on equity research entitled "Security Analysis."

Bob Farrell is famous for his 10 Rules of Investing. Rule #1 states "**Markets Return to the Mean Over Time"**. This is the basis for much of our long term strategy. Mean reversion has happened over and over again in the markets, yet many investors ignore it.

Ben Graham, (Warren Buffett was a student of his at Columbia) is a guiding light for our investment strategy. Here are a few of his quotes:

- *"An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative." — Benjamin Graham, The Intelligent Investor*
- *"Successful investing is about managing risk, not avoiding it." - Benjamin Graham*
- *"And back in the spring of 1720, Sir Isaac Newton owned shares in the South Sea Company, the hottest stock in England. Sensing that the market was getting out of hand, the great physicist muttered that he "could calculate the motions of the heavenly bodies, but not the madness of the people." Newton dumped his South Sea shares, pocketing a 100% profit totaling £7,000. But just months later, swept up in the wild enthusiasm of the market, Newton jumped back in at a much higher price—and lost £20,000 (or more than $3 million in today's money). For the rest of his life, he forbade anyone to speak the words "South Sea" in his presence." — Benjamin Graham, The Intelligent Investor*

In a seminar I attended many years ago, Sir John Templeton said he required his mutual fund managers to read 2 books before they start managing money. One was Ben Graham's Security Analysis (1934) and the other was Extraordinary Popular Delusions and the Madness of Crowds by Charles Mackey (1841) Although these books are old, they are still relevant today. They talk about how to fundamentally research a company and how human nature can go to extremes. A couple of famous quotes from Mackey are:

- *"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, one by one."*
- *"We find that whole communities suddenly fix their minds upon one object, and go mad in its pursuit; that millions of people become simultaneously impressed with one delusion, and run after it, till their attention is caught by some new folly more captivating than the first."*

This is what we try to do - to not get caught up in the herd mentality, blindly chasing the hot sector, following the crowd off a cliff.

Jim Rogers was one of the most successful money managers in the 20th century. What makes his success so impressive was that he did it during the 1970's, well before the bull market that started in 1982 and well before the Fed started putting their thumb on the scales in 2009 and again in 2020. Jim Rogers is much more direct and gruff than the others, but he is also brilliant. Here are a few of his quotes:

- *"Bottoms in the investment world don't end with four-year lows; they end with 10- or 15-year lows." - Jim Rogers*
- *"The biggest public fallacy is that the market is always right. The market is nearly always wrong. I can assure you of that." - Jim Rogers*
- *"Most successful investors, in fact, do nothing most of the time." - Jim Rogers*
- *"…bear markets go down 50, 60, 70% this is just history. This is not an opinion and many stocks go down 80, 90%. Some disappear. That's just the way bear markets work." - Jim Rogers - Business Insider 4/13/2020*
- *"Who's going to save us?… (regarding the Federal Debt) The Easter Bunny. That's who's going to save us. If you listen to Washington DC or London or Tokyo, the Easter Bunny is going to save us. Don't worry." - Jim Rogers - Business Insider 4/13/2020*
- *"…one of the things that history teaches us is people don't learn the lessons of history." - Jim Rogers - Business Insider 4/13/2020*

The first influence on my investment philosophy was around 1972. My father (an FBI fingerprint expert) gave me a book when I was about 14. It was called Fleecing the Lambs, by Christopher Elias. About the book, the NY Times said, "*How the NYSE defrauds the public …disclosures so explosive, that the Street tried its best to stop the book.*" I was fascinated by how the public was so easily duped so I got into the business to be one broker people could trust.

A fiduciary responsibility to the investors, sound fundamental research, risk management, discipline and avoiding getting caught up in the manias that so many get swept up in, are the basics of our investment philosophy. The recent market rally is the perfect example of a mania that violates all of these rules. It is not based on fundamentals, it is driven by speculation, it has taken stocks to extremely risky levels and to jump in with both feet would violate our fiduciary responsibility.

2 – Why didn't you jump into the rally?

The market never got down to "cheap" valuations. As Jim Rogers says, markets bottom with 10 to 15 year lows. Looking at the DShort chart on valuation, (companion piece) the market value in 2020, at "the bottom" in March, didn't even get down to the highs before the 2008 collapse, so there is potentially a lot more downside.

Contrary to what many think, the market has stalled and has gone sideways for the past 2 months.

Stock valuations are based on earnings. When the market bottomed in March, no one had any idea how bad the 2nd quarter GDP numbers were going to be, except for some very cryptic forecasts of "very bad." We were in good company because Warren Buffet announced he made no purchases either. Now we know the GDP was down 33%, the worst decline since the Great Depression, much worse than the 2008 recession, which brought the market down 50%. This will surely have a negative impact on earnings.

As for the Tactical Strategy, we have to stay disciplined there as well. The snap-back rally was so fast that the technical indicators were lagging well behind the market. Buy signals didn't occur for many sectors until the rally had just about peaked. And the speed at when the rally occurred implied a weak rally that could reverse just as fast. The risks were not worth exposing investor money. Since the end of May, the market has actually gone sideways, with wide volatility lasting several days. Again, this does not give good trading signals. A buy signal today could be reversed 2 days from now at a 5% loss.

Although the market has gone sideways, the past 2 months have been volatile. This type of volatility, each move lasting only several days, makes it difficult to trade the Tactical. Today's buy signal can be erased 2 days later.
Better, tradable trends are ahead of us.

I would loved to have perfectly timed the market bottom in March and ridden the wave back up in April and May. But that is not how it works. The stocks that rallied were already overvalued and just got more overvalued. The Fed dumping trillions into the system was like giving a line of shots to a drunk. Yes, he looks like he is having a good time, for now, and maybe you might even want to have that good time yourself, but eventually, the next morning, he pays the price. The market will pay the price as well. Markets revert to the mean. Bob Farrell's first rule.

A narrow group of stocks is driving the market up. Because the market is capitalization weighted, the bigger a stock, the bigger its impact on the index. Apple Computer has a much bigger share of the NASDAQ than Apple Hospitality, so when the first rises 5%, it impacts the market, when the 2nd rises 5%, few notice.

To show how narrow the upward move has been, of the 3,545 stocks in the S&P Total Market Index, 68.55% are still 20% below their 52 week high, according to data from Ycharts. That is 2/3rds of the market are still in a bear. Narrow markets are not strong markets.

3 – How strong are my convictions?

Our philosophy has been developed over a 35 year career. It is based on the work of some of the best minds in investment history. I've seen crashes, manias and manipulations. I can handle crashes and manias. It is the manipulations that concern me the most. Manipulations usually end very badly, worse than had they not done anything at all. The cure it worse than the disease. Where would we be today had the Fed not pumped trillions into the system in 2009 and the subsequent years? There would be much lower debt levels and very likely a stronger economy. Today, politicians could change the game on a dime, stopping the Fed from pumping even more money into the system. With an upcoming election, there is too much uncertainty to trust the Fed.

4 – What changes am I willing to make?

We are starting to now selectively pick up some stocks that didn't fully participate in the rally. Since the Fed hasn't run out of ink, we have to figure a repeat of 2009 - 2015 could be in front of us. (Although we still expect a re-test of the March lows.) It would be insane if the Fed continued to pump money into the system because one of two things could happen:
1) It would drive valuation to highs never seen before, making the market riskier and riskier with each uptick.
2) It could cause the Dollar to crash, possibly bringing with it inflation, higher interest rates and a much lower stock market that the Fed can't fix by pumping more money. Since the market bottomed in March, the Dollar is down about 10%.

So considering these risks, riding the wave with stocks that have reasonable valuations is a safer way to do it.

On the other hand, if there is a change in the political winds, and the Fed is told to stop, we have the ability to get out quickly. We are watching the election closely as there may be a sea change at the Fed that would require fast action. We have already verified there is a fast way to sell out with the Schwab trading system.

5 – How can I be more flexible in the future?

If by flexible, you mean willing to put investor money at undue risk, then we will not get that flexible. Our duty is to first "*consider the probable income, as well as the probable safety of the capital to be invested.*"

We fully expect a re-test of the Spring low. This is also one of the reasons we have kept our powder dry. History shows that the first decline in a recession is usually not the last. And with such an emotional rally, it is likely to wither on any disappointment on the vaccine front, or a second round of the virus, or a double dip recession, or, or, or, or…. There are so many issues going on this year, it is a wonder that the market rallied at all. It is a testimony to how much investors are willing to speculate in the face of dire social, political, medical and economic circumstances. That is not a compliment. It is an example of the Madness of Crowds.

Anyone that finds themselves chomping at the bit to get heavily into the market should do a check on their emotions. Is your desire reactionary, or based on well thought out fundamentals? The fundamentals do not support being fully invested.

By staying disciplined, we are able to keep our feelings out of the investment process. We anticipate, not react. This is a long term process. The short term cash injections the Fed has done is like giving drugs to an addict. Of course the market its going to like it, but it isn't good for it. And it only makes the problem worse.

First, do no harm. The Fed doesn't seem to know that.

Thank you,

John J Riley, AIF
Chief Strategist

2 More from Jim Rogers:
"Beware of all politicians everywhere. They excelled at recess when they were in school but have excelled at little since."
"They wouldn't be politicians if they knew what they were doing."

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[Various indexes were chosen that are generally recognized as indicators or representation of the stock market in general. Indices are typically not available for direct investment, are unmanaged and do not include fees or expenses. Some indices may also not reflect reinvestment of dividends.]

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