Investment Insights

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The Model Wealth Program
Principle-Based Investing

"Principal-based investing means we focus on investment principals that have stood the test of time rather than basing our decisions on short-term market predictions. Our goal is to identify a small number of experienced managers who offer the potential to outperform their peers over a long period of time. Our approach is to combine a well-defined quantitative and qualitative due diligence process with proprietary construction tools to build, manage and monitor our client's portfolios."

The Model Wealth Program is a managed fee-based investment program, available through Cornerstone Wealth Management, LLC. The MWP investment team has developed sophisticated long-term strategies in an effort to manage and control risk, to help investors pursue their financial goals. For more information about the program, contact your Cornerstone Wealth Management representative.

Expectations for Capital Market Returns

- While forecasts are inherently unreliable, anyone who is serious about planning for their future must make certain assumptions about future capital market returns over the long-term.
- Our approach to forecasting future capital market returns is to think about the individual components of total return, estimate their future value, and sum up the parts to reach an estimated annual return.
- These estimates are a key consideration when determining a proper asset allocation for the investment portfolios in our Model Wealth Program.

Setting realistic expectations

In this report, we are providing our updated expectations for long-term capital market returns. These estimates are a key consideration when determining a proper asset allocation for our Model Wealth Program.

We anticipate that, on average, U.S. stocks will provide an annual total return of 6.5-8% over the long-term and a well-diversified portfolio of bonds will return 3-4%. While these figures are well-below the returns experienced by investors in recent years, we believe they are based on reasonable assumptions that are appropriate for investors who are planning for their future.

Long-term forecasting

Forecasts are, by their very nature, inherently unreliable. However, anyone who is serious about planning for their financial future must make some assumptions about future capital market returns over the long-term. In our view, investors need a guidepost for planning purposes, and a greater understanding of the factors that determine investment returns. In the absence of a quality estimate of future returns, investors seem to either rely on wishful thinking or a projection of recent results. Either of these approaches is likely to lead to disappointment.

10-Year Period	Avg Annual Return S&P 500	Next 10-Year Average Return*
1926-1935	5.86	8.41
1928-1937	0.02	9.62
1929-1938	-0.89	7.26
1930-1939	-0.05	9.17
1931-1940	1.80	13.38
1937-1946	4.41	18.42
1965-1974	1.24	14.76
1966-1975	3.27	14.33
1968-1977	3.59	15.26
1969-1978	3.16	16.32
1970-1979	5.86	17.55
1998-2007	5.91	8.50
1999-2008	-1.38	15.25
2000-2009	-0.95	13.92
2001-2010	1.41	13.76
2002-2011	2.92	15.82
Average	3.28	13.23

*The historical data are for illustrative purposes only, do not represent the performance of any specific investment. **Performance data quoted above are historical. Past performance is no guarantee of future results. Current performance may be higher or lower than the performance data quoted.** Source: Morningstar. Next 10-years, or longest available period as of August 20, 2018.

Although the average annual total return on stocks from 1926-2016, as measured by the S&P 500, was 10.0%, there have been shorter periods of time when the return on stocks was very disappointing.

Relying on recent experience to set an expectation of future returns can be a big mistake. The table on the left shows the 10-year rolling periods since 1926 when stocks earned less than 6%. As you can see, disappointing 10-year periods were often followed by periods of very robust performance. The rebound was often driven by a better economy. According to the table, this recovery has proven to be no different.

Forecasting future returns

In our view, a better approach to forecasting future returns is to think about the individual components of total return, estimate their future value, and sum up the components to reach an estimated return. Below, we examine the four components of total return for the S&P 500 since the turn of the century, the beginning of modern data reporting techniques, and the end of World War II.

	1900-2017	1926-2017	1946-2016	10-Year Projected*
Inflation	3.1%	2.9%	3.7%	2.0-3.0%
Dividend Income	4.4%	4.1%	3.7%	2.0%
Real Dividend Growth	1.4%	1.8%	2.5%	2.5-3.0%
Valuation Shift	0.6%	0.9%	0.5%	0.0%
Nominal Total Return	**9.7%**	**10.0%**	**10.8%**	**6.5-8.0%**

Source: Robert Shiller, S&P. Note that individual return factors do not add directly due to the compounding effects between them.* Cornerstone Wealth Management estimates. Returns shown are annualized.

Inflation and Dividend Income

We believe the first two pieces are fairly easy to estimate. Inflation has averaged about 3.1% over the last 100 years or so, but was significantly influenced by very high rates in the 1970s and early-1980s. Excluding the data from 1970 to 1985 moves the long-term average down to 2.5%. For this reason, many economists feel the rate of inflation will be lower in the future. (Source: Morningstar) A rough estimate of the dividend income can be pulled from the current dividend yield on stocks, which according to Bloomberg is 1.90%.

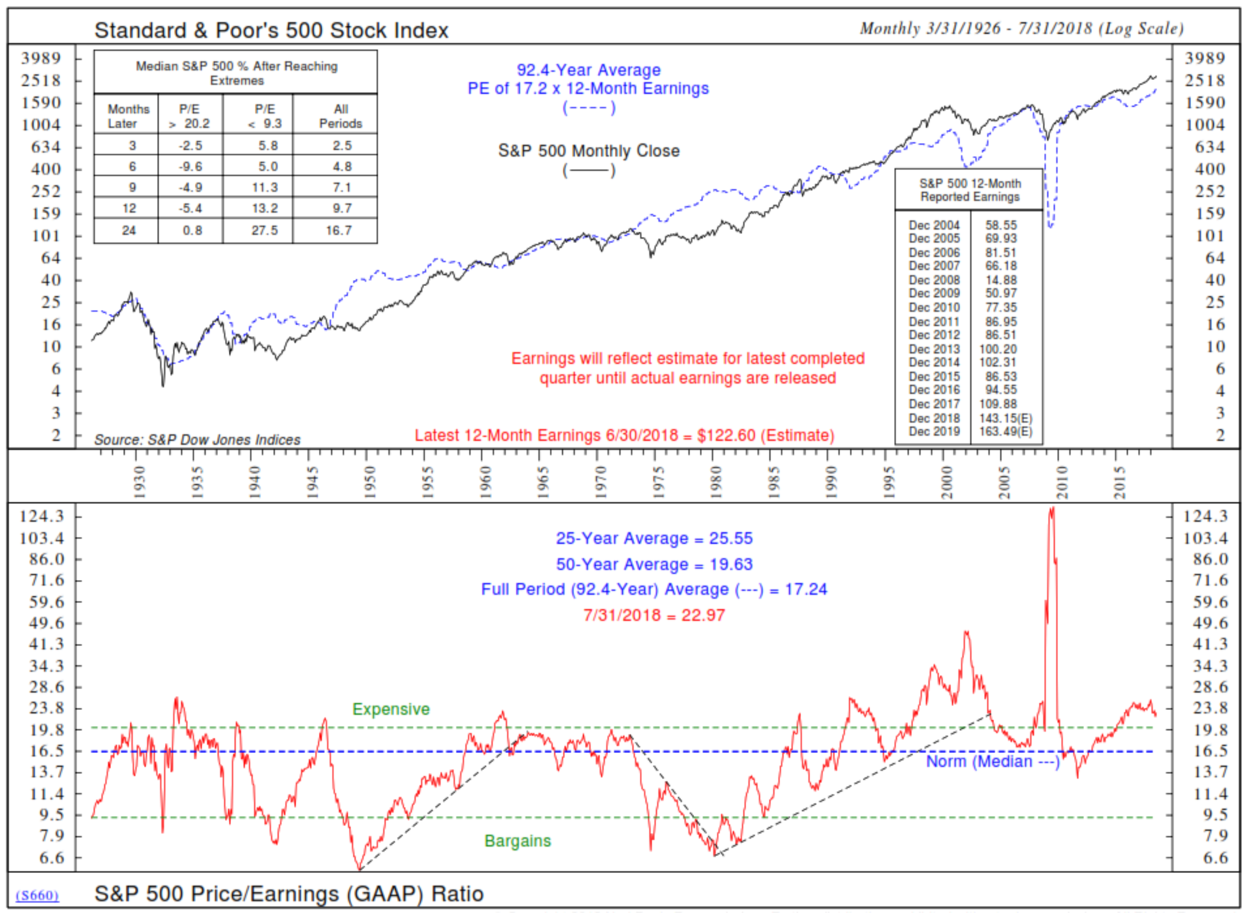
Real (after-inflation) dividend growth and changes in valuation are the primary drivers to capital appreciation for stocks, so let's address these one at a time.

Dividend Growth

The primary source of dividend growth is earnings growth. Nominal earnings per share for the S&P 500 has grown at a rate of 4.7% since 1900, 5.0% since 1926, and 6.8% since the end of World War II. Of course, these figures include inflation. The real (after-inflation) growth in earnings for each of these time periods was 1.6%, 1.9% and 3.1% respectively. Earnings grew faster in the post-war period for several reasons. The economy has transitioned from agriculture and manufacturing to services. A service economy is generally less capital intensive, which has allowed profit

	1900-2017	1926-2017	1946-2017	10-Year Projected*
Nominal Earnings Growth	4.7%	5.0%	6.8%	6.0%
Real Earnings Growth	1.6%	1.9%	3.1%	3.0-4.0%
Nominal Dividend Growth	4.4%	4.8%	6.1%	5.0%
Real Dividend Growth	1.4%	1.8%	2.5%	2.5-3.0%
Beginning Dividend Payout	63%	56%	67%	41%

Source: Robert Shiller, S&P. Note that individual return factors do not add directly due to the compounding effects between them.
* Cornerstone Wealth Management estimates.



margins to improve. The date after 1946 does not include the Great Depression, a period of unusually low earnings growth. It's also worth noting that, according to data compiled by S&P Dow Jones Indices, companies in the S&P 500 generated 71% of their revenue in the U.S. in 2017, with the remainder generated overseas. As you can see, nominal and real dividend growth grew in correlation with earnings growth as companies passed along profits to investors. Given post-war economic trends, we expect future real dividend growth to continue to be in the 2.5-3.0% range.

Valuation

The last component of total return is the shift in valuation, as measured by the price/earnings ratio. The chart on the preceding page shows the price/earnings ratio for the S&P 500 (price/past 12 months earnings based on generally accepted accounting principles (GAAP)). When interest rates and inflation are very low, stocks tend to trade at higher price/earnings ratios. This has been the case for much of the past 15 years, with the exception of a brief time during the Financial Crisis in 2008. Today, the price/earnings ratio of 23 for the S&P 500 is actually below the 25-year average of 25.55, but slightly higher than the 50-year average of 19.63.

Some market analysts use the price/earnings ratio as a market timing tool. However, valuation is a very unreliable guide for predicting the stock market. Since the stock market trades at a price/earnings ratio of 20 times estimated year-end earnings of $143 for the S&P 500 (Source: Ned Davis Research), we assume that valuation will neither add-to nor detract from future returns.

Assuming low to moderate inflation, steady dividend income and dividend growth, and no change in price/earnings ratios, we assume the stock market will return 6.5-8% per year over the long run.

Forecast for Bonds

The expected return on bonds should be roughly equal to the coupon payment, which is approximately 3% for Government bonds, and 4% for investment grade corporate bonds (Source: Bloomberg, as measured by the Bloomberg Investment Grade Corporate Bond Index). Given our current expectations for inflation, we expect interest rates to rise modestly from current depressed levels. Since 1900, bond investors have typically demanded a return of about 2% above inflation. For these reasons, bonds purchased in the future should produce moderately higher returns. We take the conservative stance that return on bonds will be around 3-4% in the coming 10 years.

While we expect future returns on stocks to be somewhat lower than the past, we also believe inflation and interest rates will be lower. Therefore, the potential premium that stocks offer over a 1-Year Treasury Bill may actually be very similar to the past. This is illustrated in the table below.

Annual Total Returns	1900-2017	1926-2017	1946-2017	10-Year Projected*
Return on Stocks	9.7%	10.1%	10.9%	6.5-8.0%
Return on T-Bills	4.4%	4.2%	4.9%	2.0-3.0%
Equity Risk Premium	5.4%	5.9%	6.0%	4.5-5.0%

Source: Morningstar. *Cornerstone Wealth Management estimates.

Will history repeat?

While history can serve as a guide to future returns, it's not the only basis for our estimates. There are several reasons to believe that over long periods of time, stocks should return more than bills or bonds. First, stock investors often demand a higher return on stocks and price them accordingly. This is due to the extra risk inherent in owning stocks. Unlike bonds or bills, there is no promise to receive a fixed rate of interest or principal back at maturity.

Second, stockholders have the potential to profit from growth in the enterprise they've invested in through their claim on earnings and dividends.

Finally, stocks, unlike bonds, have the potential to benefit from inflation. Inflation causes bondholders to receive dollars that are worth less at maturity, while stockholders benefit from a corporation's ability to pass rising costs on to their customers in the form of rising prices. While future returns on U.S. stocks may be lower than the past, they should still be significantly higher than the returns on other asset classes.

Important Disclosures

The information contained in this report is as of August 20, 2018 and was taken from sources believed to be reliable. It is intended only for personal use. To obtain additional information, contact Cornerstone Wealth Management. This report was prepared by Cornerstone Wealth Management. The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual.

To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. Content in this report is for general information only and not intended to provide specific advice or recommendations for any individual. Economic forecasts set forth may not develop as predicted and there can be no guarantee that strategies promoted will be successful. Investing involves risk including the potential loss of principal. No strategy can assure success or protection against loss. Past performance is no guarantee of future results.

Securities offered through LPL Financial, Member FINRA/SIPC.

Stock investing involves risk including loss of principal. The payments of **dividends** is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time. **The Standard & Poor's 500 Index** is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **Bloomberg Global Investment Grade Corporate Bond Index** is a rules-based, market-value weighted index engineered to measure investment grade, fixed-rate securities publicly issued in major domestic and euro-bond markets. All indices are unmanaged and may not be invested into directly.

Bonds are subject to credit, market, and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

The future is bright

The Model Wealth Program uses these conservative estimates to construct portfolios with the appropriate mix of stocks and bonds. An appropriate asset allocation should be able to help investors reach their long-term goals of growth, income, and diversification.

Some investors might believe a total return of 6.5-8% is uninspiring. However, at a 6% rate of growth, money should double approximately once every 11 years. At 8%, that doubling should occur once every 9 years. (Does not include taxes or expenses) Of course, in our Model Wealth Program, we attempt to identify managers that offer the potential to perform better than the market averages, although this cannot be assured.

We believe this is a great time for investors with long-term goals like saving for retirement, to put money to work. While the stock market will likely continue to be volatile, we also believe returns will be higher than most other asset classes. If that happens, it's likely that there will be two types of investors in the years ahead: Those who say, "I'm glad I did" and those who say, "I wish I had."

We believe the Model Wealth Program is well-positioned to take advantage of the opportunities in the market. For investors with long-term goals, like saving for retirement, our suggestion continues to be: stay the course.

Cornerstone
WEALTH MANAGEMENT LLC
A Registered Investment Advisor