Investment Insights

March, 2018

Alan F. Skrainka, CFA
Chief Investment Officer

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.

Dealing with Difficult Markets

How to invest when markets are volatile

With the return of volatility in the stock market, we thought we would share with you some of our favorite investment principles, which may come in handy if market volatility continues.

Invest for the long-term

Stocks are one of the most volatile asset classes in the short run, but historically have offered high returns over long periods of time.

Avg Annual Return	1928	1945	1992
S&P 500	6.80	6.96	7.32

Source: Ned Davis Research. Past performance may not be an indicator of future results. Includes dividends reinvested but does not include taxes or fees.

Since 1926, the stock market has risen in 68 of the past 91 years, or 75 percent of the time. Historically, the odds of success increase dramatically the longer you hold your investments. The stock market, as measured by the S&P 500, rose 83 percent of the time over 3-year periods, 86 percent of the time in 5-year periods, and 95 percent of the time in 10-year periods since 1926. (Source: Morningstar). The stock market is a perfect tool for transferring wealth from impatient people to patient people.

Why did this happen? To quote Warren Buffett, "In 1776, America set off to unleash human potential by combining market economics, the rule of law, and equality of opportunity. This foundation was an act of genius that in only 241 years converted our original villages and prairies into $96 trillion of wealth."

Volatility is normal

Volatility is normal for the stock market. Though the annual return on stocks (as measured by the S&P 500 has averaged 10.0 percent since 1926 (before inflation), the return was between 8 and 12 percent in only six calendar years out of the past 91. (source: Morningstar). That means, 93 percent of the time, your return in the stock market is less than 8, or greater than 12 percent. In the long run, the stock market reflects the steady long-term growth rate in the economy and corporate profits. In the short-run, it reflects a volatile cycle of emotions, ranging from euphoria to despair.

Corrections are a normal part of the investing process

With the Dow Jones Industrial Average around 26,000, we'll likely get a correction of 2,600 points or more this year, next year and the year after that! That doesn't bother me, and it shouldn't bother you. Since 1900, we've experienced 125 corrections of 10 percent or more. That's a little more than one a year. Corrections are a normal part of the investing process, and not a reason to sell good investments. Since 1980, we've had positive annual returns in 28 of the last 37 years, or 75 percent of the years, yet we experienced double-digit corrections in 21 of those 37 years. This occurred over a period when the Dow rose from 839 to over 26,000. (Source: Ned Davis Research) And of course, this happened in spite of recessions, 911, the tech bubble bursting, Y2K, elections, the Great Financial Crisis, and many, many new all-time highs. A long-term bet against the U.S. stock market has always been a bad bet.

Key Takeaways:

- Stocks are one of the most volatile asset classes over the short-run, but historically have delivered higher returns over longer periods of time.
- Volatility is normal for the stock market, and corrections are a normal part of the investing process.
- There are two goals of professional investment management: earning a competitive return and managing risk. If you forget about managing risk, you are never going to earn the competitive return.
- On February 5th of this year, the Dow Jones Industrial Average dropped 1,175 points in a single day. While it was the largest point drop in stock market history, it ranked only 156th on a percentage basis.

No one can predict the future

The vast majority of short-term predictions, especially on the part of pundits, politicians, economists and other experts will likely be wrong. According to research conducted by independent statistician Salil Mehta, the stock market year-end forecast from the top strategists on Wall Street over the past 18 years performed worse than the flip of a coin. In fact, more than half the time since 2000, the miss has been either too high or too low by more than 9 percent. (Source: WSJ, November 23, 2017). In addition, not a single one of the 50 economists surveyed by the firm "Blue Chip Economic Indicators" predicted even a mild recession leading up to the 2008 Great Financial Crisis, which was the worst downturn since the Great Depression.

Managing risk

If you are investing money, it's a really good time to be careful. In fact, it's always a good time to be careful. Never own an investment today you wouldn't want to own in a bad market tomorrow. And don't underestimate the importance of lower return, less volatile investments like bonds. There are two goals of professional investment management: earning a competitive return and managing risk. If you forget about managing risk, you are never going to earn the competitive return. Investors should own quality investments in a professionally-managed, broadly-diversified portfolio that can be bought and

Managing risk (cont.)

held over the long-term. That portfolio should be managed, monitored and rebalanced to maintain consistency with your risk tolerance. Most people overestimate their tolerance for risk when times are good, then want to get more conservative after the market falls. The best mix of stocks, bonds and other assets is the mix that will help you achieve your long-term goals, that you can stick with in good times and bad.

Diversification

Some companies will prosper, others will fail, but most individual stocks will turn out to be poor investments. According to research conducted by Hendrick Bessembinder, a finance professor at Arizona State University, most stocks do not even beat the low returns of one-month Treasury Bills. In fact, in his research paper titled, “Do Stocks Outperform Treasury Bills”, which came out last year, only 4 percent of all publicly traded stocks account for *all of the wealth* over and above a T-bill earned by investors in the stock market since 1926. Most of these extraordinary companies were very difficult to identify ahead of time. The professor also points out that the average stock is only around for 7 1/2 years. Unfortunately, many of the stocks that are most poplar today will likely provide the lowest returns in the years ahead. Many of the stocks that are very unpopular today will likely have the highest returns. In our dynamic economy, leadership changes very quickly. It has always been baffling to me how many investors un-diversify otherwise diversified portfolios based on the belief that they have an information edge over the stock market.

Only 4 percent of all publicly-traded stocks account for all of the wealth over and above a T-bill earned by investors in the stock market since 1926.

The truth is, most people do not have the time, willingness, resources, discipline or expertise to make these decisions. What’s an investor to do? In my opinion, the most diversified portfolios have thousands of stocks and bonds, with a variety of different investment managers, overseen by a team that can monitor, manage, and rebalance that portfolio when necessary. This is how we manage money in our Model Wealth Program. Our investment team spends nearly all of our time identifying strong investment managers, then we build diversified portfolios of those managers that our clients can own.

On February 5th of this year, the Dow Jones Industrial Average dropped 1,175 points in a single day. While it was the largest point drop in stock market history, on a percentage basis, it was only the 156th largest drop in market history.[2]

Performance Chasing

Many investors who invest in mutual funds will experience performance that is worse than the funds they’ve invested in. Research from Hsu, Myers, and Whitby (2015) showed that investors earn about 2 percent less per year than the mutual funds they invest in because of a bias towards chasing hot performance. In other words, they buy those funds after they’ve performed well, then sell them after they’ve underperformed. Every mutual funds manager has a style, and that style tends to cycle in and out of favor just like the financial markets. Dalbar Research shows that the average investor[1] earned just 2 percent per year over the last 20 years, which could largely be due to poor market timing and poor investment selection. Recent past performance isn’t just meaningless, it’s actually harmful to the investor as this research shows, yet it’s the key variable that most investors use. Of the 18 different criteria we’ve tested for selecting mutual funds, recent short-term performance has the least predictive value.

1: Based on analysis by Dalbar, which uses the net aggregate of mutual fund sales redemptions and exchanges each month as a measure of investment behavior. Return amount given is an annualized figure.

2: Source: Yahoo Finance

DataBank

	1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large Stocks	18.5	11.5	15.0	9.7
U.S. Small Stocks	12.6	9.5	12.6	9.9
U.S. Bonds	0.7	1.2	1.8	3.7
Intl Developed Mkts Stocks	21.6	6.9	6.6	3.0
Intl Emerging Mkts Stocks	30.6	9.9	5.4	3.0
U.S. Inflation (CPI)	1.5	1.8	1.4	1.6

Source: Morningstar. Annualized returns for periods ended February 26, 2018. U.S. large stocks is the S&P 500 Index, U.S. small stocks is the Russell 2000 Index, U.S. Bonds is the Bloomberg Barclays US Aggregate Bond Index, Intl Developed Markets is the MSCI All Country World Index Ex-US, International Emerging Markets is the MSCI Emerging Markets Index. Returns include dividends and interest. Investing involves risk including the potential loss of principal. No strategy assures success or protects against loss. Past performance is not an indication of future results.

Important Disclosures

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and may not be invested into directly. Economic forecasts set forth may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

Stock and mutual fund investing involves risk including loss of principal. Bonds are subject to 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.

Hypothetical examples are not representative of any specific situation. Your results may vary. The hypothetical rates of return used do not reflect the deduction of fees and charges inherent to investing.

The Model Wealth Program: Principles, not predictions

The Model Wealth Program offers a strategy for investors who choose to embrace principle-based investing. Working in partnership with your advisor, our program offers a comprehensive strategy for clients who wish to have their investments professionally monitored, managed and rebalanced as market conditions change. We attempt to mitigate investment risk by offering broadly-diversified portfolios of professionally-managed investments. While not a panacea against loss, diversification can help reduce risk by dampening wide price swings and minimizing an investor's exposure to any one security, asset class or manager. We monitor our managers and make changes if results fall short of expectations. Building a portfolio of multiple managers provides the opportunity for diversity of opinion and can reduce the impact of one manager's miscalculations or mistakes. We also rebalance the portfolio when market conditions push the portfolio out-of-balance in an effort to maintain a steady level of risk consistent with your long-term goals and objectives.

Our program also features objective advice. Unlike many other advisory programs, we have no financial arrangements, such as revenue sharing, with the firms that are represented in your portfolio. This gives us access to a larger universe of investment managers, not just those willing to pay to be on a buy list. We believe a professionally-managed advisory account can help take the emotions out of the investment decision-making process, and offers an attractive strategy for investors with long-term goals, like saving for, or investing in, retirement.

We've also recently introduced a program which allows for monthly, systematic investing. If this sounds attractive to you, speak to your financial advisor about investing in our Model Wealth Program today.

Cornerstone
WEALTH MANAGEMENT LLC
A Registered Investment Advisor