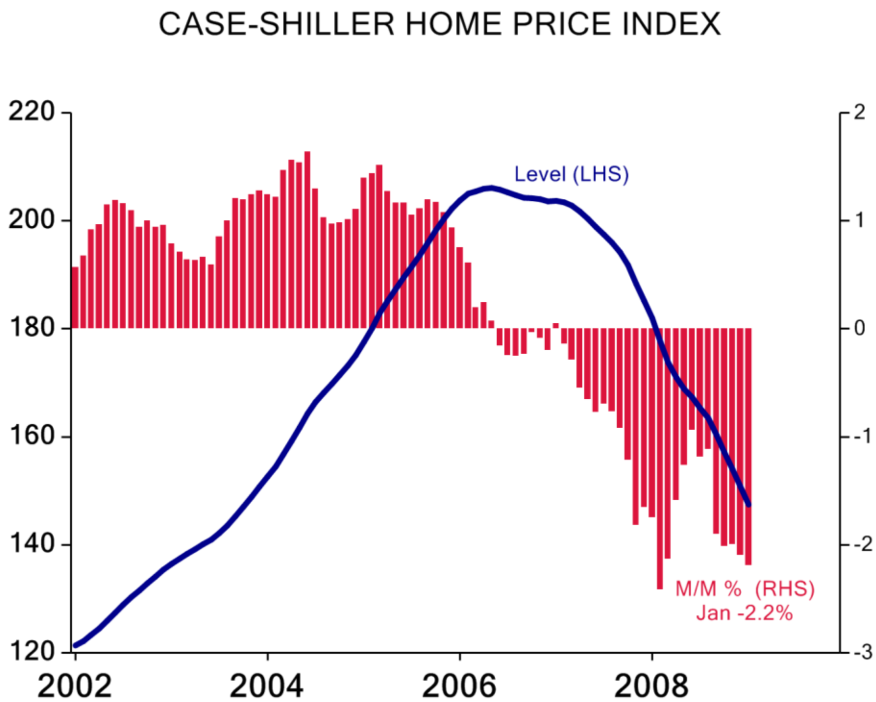
“The Pendulum Swings: Part II”
First Quarter 2009 Investment Perspective and Outlook
Cornerstone Capital Management, Inc.
April 1, 2009

Last quarter, we wrote about some of the pendulum-like swings from one extreme to another that we are seeing in the economy generally and in the financial markets in particular. We stated that as a result of these swings, the opportunity for profit in the period ahead seems particularly large for those of us who are investing in the equity market. It appears that those movements have begun in a significant way.

Despite many fits and starts, the federal government’s monetary initiatives to restore liquidity to the credit markets are working. We endorse the monetary policy that has been implemented and see that credit is available for credit-worthy companies and individuals, albeit at still elevated premiums.

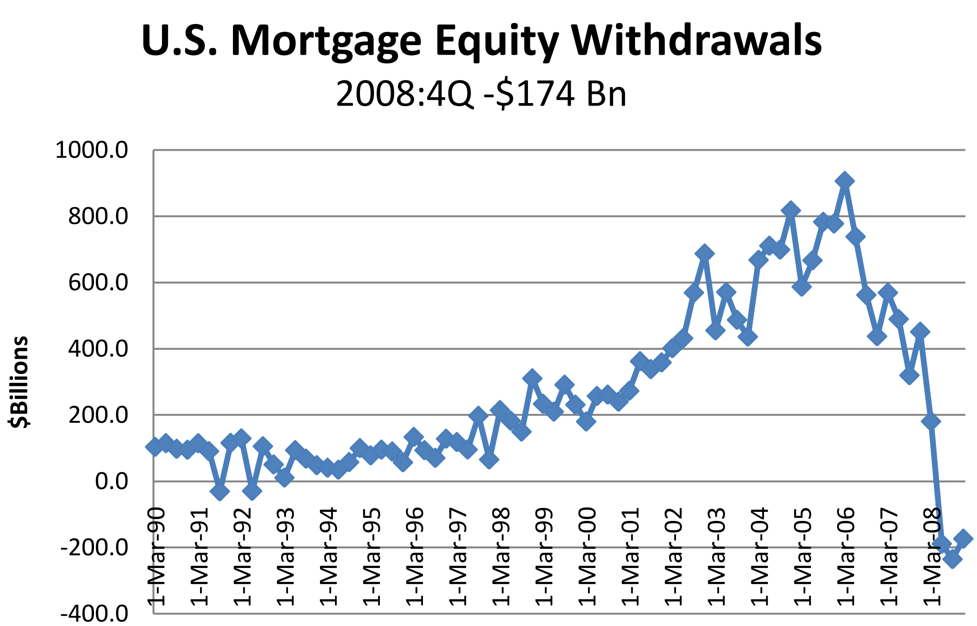
Unfortunately, fiscal policy, legislative actions, and regulatory actions have caused confusion and fear among investors leading to the market downturn, which formed a new bottom on March 9th. The financial and economic crises are being used to make sweeping changes in the rules for operating and investing in a business. Stress tests for our nation’s largest banks, new accounting rules, new minimum capital ratios, compensation and travel restrictions, and forced equity issuance to the US government, all yet to be defined, have pummeled the valuation of financial and other institutions. Bankruptcy law changes which would allow primary mortgage contracts to be abrogated for the first time added fuel to the fire. The proposal to tax global income will put US based multinational firms at a disadvantage to foreign competitors and will have the unintended consequence of hurting job creation in this country. Raising capital gains tax rates will reduce the incentive to invest in the small private enterprises that are the key to our economy. Government borrowing on an unprecedented scale will crowd out investment in the next generation of innovation needed to drive our economy. The first bill signed into law by the new administration, The Lilly Ledbetter Fair Pay Act, greatly expands workers’ rights to sue, relaxing the statute of limitations. Most concerning, card-check legislation has been introduced which strips workers of their right to a private-ballot vote in union elections, requires companies to submit to binding arbitration, and increases penalties for unfair labor practices committed by employers but not by unions. Each of these items, unless modified in the months ahead, will retard and mute the cyclical recovery and resurgence of capital formation that would otherwise occur with free markets.

According to the latest Case-Shiller data, home prices continue to slide with only seven of 20 markets showing flat or slower sequential monthly declines. The silver lining is that homes are rapidly turning over in the most distressed areas where prices have fallen to a clearing price. We still expect home prices to stabilize by the first quarter of 2010. While the unemployment rate has now hit 8.5% and we anticipate over 10.5% by early next year, consumer sentiment per the Conference Board edged higher in February off of record lows in January. Retail sales are still down year over year, but are down less than the double-digit percentage rates seen in 4Q2008.



Source: ISI Group and Standard & Poor's.

This is happening despite still negative Mortgage Equity Withdrawals (i.e. net mortgage payoffs/reductions instead of increases). As consumer fear subsides, we expect the savings rate to moderate providing a tailwind for retail sales.



Source: ISI Group and US Commerce Department.

While these legitimate economic concerns persist and the rules of operating a business are in flux, the range of possible downside outcomes is narrowing, giving investors confidence that we are at or near a bottom. As a result, the market rebounded 18% off the March 9th lows. Due to the enormity of cash balances ($8.85 trillion in cash, bank deposits, and money market funds – enough to buy back 74% of the market cap of US companies[1]) and low leverage ratios, any positive news, even less bad news, is being rewarded with more capital deployed and a positive bias to the market. The record levels of intraday volatility we are experiencing are an indicator to us that we are experiencing a bottoming process. The current low government bond yields due to deflationary concerns will give way to higher bond yields needed to attract and retain capital. As business conditions improve for slimmed down companies, profitability will recover and equity returns should trump all asset classes by a significant margin in the years ahead.

During periods of stress, it is very tempting to chase relative performance. We resisted and continue to resist this temptation. Our process of individual stock selection based on finding perception gaps in key metrics that drive the financial statements of the companies we own has not changed. We maintained an aggressive posture into the market bottom on November 20th and again on March 9th since we believed and continue to believe that the market was significantly oversold. Our process and style consistency has been rewarded with significant alpha since then (driven almost entirely by individual stock selection). In fact, attribution analysis indicates that we generated 400 bps of positive alpha from security selection alone in the 4th Quarter of 2008 and 420 bps in the 1st Quarter of 2009. We are pleased with these results.

We had structured the portfolio last fall with somewhat of a barbell approach. At one extreme we have invested in large, industry dominant companies with large cash balances that are able to cut costs and weather what could be an extended economic downturn (i.e. ORCL, HPQ, QCOM, TGT, ABB, SLB). At the other extreme, we have invested in some smaller, more volatile names that would benefit from an early cyclical turn in the market. These names are generally more focused companies that dominate a particular segment of the market (i.e. ADBE, GES, HES, HK, ICE, FSLR). We searched for companies at this end of the barbell that also had net income confirmed by cash flows. We have overweighted the technology sector by 6.3 percentage points relative to the Russell 1000 Growth Index due to fact that technology stocks currently offer by far the highest price to cash flow yields at 10% vs. the market at 7.5%.

We indicated last quarter that a number of our companies would make attractive acquisition targets. In fact, we were fortunate to have two stocks that were acquired during the quarter, Genentech and Schering-Plough. These two companies, like other holdings in the portfolio, have strong industry positions, exciting product pipelines, healthy cash flows, and a low enough valuation that they were attractive to potential acquirers. We expect industry consolidation to accelerate in the months ahead as management teams begin to sense some stability in order patterns.

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1. Keene, Thomas R. et. al. Bloomberg L.P. “Cash at 18-Year High Makes Stocks a Buy at Leuthold”. December 29, 2008.

We believe this is a once in a lifetime opportunity to invest in business franchises at historic low valuations before the pendulum swings back in a positive direction. We continue to look forward with eager anticipation.

Thank you for the confidence you have placed in us.

Thomas G. Kamp
Chief Investment Officer