

“The Pendulum Swings”
Fourth Quarter 2008 Investment Perspective and Outlook
Cornerstone Capital Management, Inc.
January 1, 2009

Astute observers are accustomed to seeing oscillations in many different facets of life. Tides and political power rise and fall, the sun rises and sets, and the seasons change, etc. Such oscillations are often compared to a clock pendulum which begins to swing back toward the middle after reaching an extreme. The financial markets are experiencing a pendulum like swing on many different levels. As a result, we believe there is an opportunity for profit in the period ahead for those of us who are investing in the equity market.

Much has been written about America’s housing bubble and the excesses that it contained. Low interest rates, loans to subprime borrowers, and a nearly uninterrupted history of rising home values led many people to purchase homes beyond their means. More broadly, consumers have had increasing access to credit over the last 40 years. Consumers graduated from charge cards to credit cards, to home equity loans that match the value of their homes, to cash out refinancings, to auto loans and leases, to deferred billing on everything from consumer electronics to even apparel.

As the pendulum of consumer credit begins to swing back, we will face at least a few years of painful retrenchment in consumer spending. Credit contraction is occurring at all financing levels for both corporations as well as consumers. Home equity lines are getting slashed. Credit card fees and interest rates are rising and credit lines are getting cut. Revolving credit lines to many businesses are also getting pulled.

The ramifications of the credit contraction have led to a downward spiral of reduced business activity, job and wage cuts, plunging consumer confidence, and drops in consumer spending. Earnings estimates are being slashed and forward visibility for most companies is abysmal. The swiftness and severity of the market downturn in 2008 was staggering as some of the bedrock institutions of our country failed or neared failure. Investor anxiety became self fulfilling in September through November as investor fears caused liquidity crises from Wall Street to Main Street.

In our opinion, the current state of the markets is one of tense, but easing anxiety. Consumer confidence is at a historic low. Business activity has slowed to a crawl since October in everything from autos, flat panel TVs, semiconductors, and mining equipment. Holiday retail sales recovered in the last few days due to heavy discounting. The fact that heavy discounting was required to motivate sales is an indicator that retail sales in the first quarter will be abnormally soft. The Federal Reserve and Treasury have injected unprecedented liquidity into the market with the Fed Funds target rate now at 0 to 0.25% and approximately \$2 trillion of government intervention into the financial markets. In addition, President-elect Obama is advocating rapid passage of a fiscal stimulus program that could approach \$1 trillion in size.

Finally, central banks around the world understand the problem and are taking coordinated action.

Current five year inflation expectations embed 15 basis points of deflation per year. We believe this and 30 year bond yields of 2.61% are illogical when one considers the monetary and fiscal stimulus described above.

The pendulum of investor sentiment has swung so negative that \$8.85 trillion is held in cash, bank deposits, and money market funds – enough to buy 74% of the market value of US companies!¹ This cash is beginning to be redeployed and is giving the market an upward, albeit highly volatile, bias. We feel the record levels of intraday volatility we are experiencing are an indicator that we are experiencing a bottoming process. We believe equity returns could trump all asset classes by a significant margin in the years ahead.

While we are deeply disappointed with the negative absolute return in 2008 and the modest negative relative return, we recognize that we did so with a quite aggressive portfolio. With the benefit of hindsight, we should have ridden the momentum in Energy and Materials on the upside early in the year before exiting midyear, avoided the value traps in Industrials and Capital Goods, and concentrated everything other than cash into Consumer Staples. Our stock selection was good in many cases, but overwhelmed by a few large detractors: Textron, Las Vegas Sands, and MEMC Electronics.

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 since we believed and continue to believe that the market was significantly oversold. Our process and style consistency has been rewarded with significant alpha added since then.

We have positioned the portfolio into companies that generally have strong industry positions, cash flows, and balance sheets in order to help them weather the liquidity and economic storm that may last for a few more quarters. We favor companies of this type whose valuations have been driven down to levels which we believe should provide attractive returns from here. We have found some Energy stocks, for example, that are trading at valuations below that of their proven reserves and give no value to their development potential. Some of our Industrial stocks are trading at less than 20% of the value of their backlog or less than 25% of their sales. Many of our stocks could be great acquisition targets for corporate or financial buyers.

We expect 2009 to be another year of near record volatility due to the cash excesses on the sidelines that are starting to come back into the equity market and the \$1.7 trillion in hedge funds. However, 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.

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

Thank you for the confidence you have placed in us. We look forward to 2009 with eager anticipation.

Thomas G. Kamp
Chief Investment Officer