






## The Capstone Investment Process

## Capstone Investment Financial Group

Is a working blend of financial coach and investment manager with a goal ... to make our clients financially secure.

- Capstone Investment Financial Group was founded on the belief that a prudent investment strategy reacts to current market conditions and does not lock a portfolio into a fixed allocation or style boxes based on prior returns.
- As an active manager, we build portfolios with the flexibility to be opportunistic and to diversify among asset classes and management styles where we perceive the greatest potential.
- Our investment management approach starts with the basic principles of Modern Portfolio Theory and expands those principles into today's universe of investment options, management styles, alternative investments and global opportunities.
- Risk management is an element of every portfolio because to succeed as an investor, you must put time and the power of compounding on your side. That requires an investment approach you will stay with for the long run, where risks do not exceed your tolerance level.

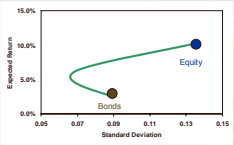




## Beyond Modern Portfolio Theory

In 1952, the publication of "Portfolio Selection" in the Journal of Finance by Harry Markowitz established Modern Portfolio Theory (MPT) and revolutionized the investment process.

- Markowitz set forth the concept that it is not enough to look at the expected risk and return of one particular stock. By investing in more than one stock, an investor can reap the benefits of diversification - chief among them, a reduction in the risk level of the portfolio.

Markowitz's Efficient Frontier, which forms the basis of fixed asset allocation strategies, plots all optimal portfolios in a given time period based on three measures - mean return, standard deviation and correlation of assets (how two securities move in relation to each other). The Efficient Frontier represents those portfolios that have the greatest return for a given level of risk. Portfolios below the curve are not efficient because for the same risk, one could achieve a greater return. A portfolio above the curve is considered impossible.





## The flawed frontier of MPT

The Efficient Frontier uses correlation coefficients to quantify which assets tend to move up or down with or against other assets. The problem is that correlation coefficients change over time.

- Studies by Rydex Investments show dramatic shifts in the Efficient Frontier from decade to decade.
- In down markets, correlations go up as all asset groups tend to get caught up in the same panic selling, negating the value of diversification.

Calculated by Rydex Investments using information and data presented in Ibbotson Investment Analysis Software. All rights reserved. Used with permission. Standard deviation (risk) is a statistical measure of the historical volatility of an investment that measures the extent to which numbers are spread around their average. Equity returns are based on the S&P 500 index, including the reinvestment of dividends and adjusted for inflation. Bond returns are based on the Ibbotson Long-term Government Bond index with dividends reinvested, adjusted for inflation. Both indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.




## Taking MPT to the next level

Capstone Investment Financial Group takes Modern Portfolio Theory and adds 55 years of technological developments and market knowledge to offer investors investment strategies that target absolute returns.

- There is no "perfect" investment, management style or asset allocation across all market conditions. Diversification by management styles, asset classes and individual securities increases the potential for your overall portfolio to experience consistent gains over changing market conditions.
- A prudent investment strategy reacts to market conditions and does not lock a portfolio into a fixed asset allocation or style boxes based on prior returns.
- If you design a portfolio by looking backwards at what has been, it's too easy to miss what might be.
- We want the flexibility to be opportunistic and diversify among asset classes where our managers perceive the greatest potential.




## Capstone investment principles

- Craft portfolios based on the individual investor's investment policy statements to fit their return objectives, risk profile and account size.
- Offer diversified portfolios with respect to assets and management styles, continually seeking uncorrelated investment approaches that reduce volatility and enhance portfolio growth without assuming undue risk.
- Protect and preserve assets from inflation, changing interest rates, and fluctuating currencies, as well as potentially poor performance in equity and fixed income markets.
- Strive to produce absolute returns in all market environments.
- Align our interests with those of the client to keep costs low and meet investment goals.



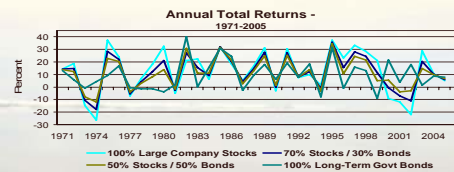
## Two components of risk



- **Systematic Risk** - These are market risks that cannot be diversified away. Interest rate movements, recessions and wars are examples of systematic risks.
- **Unsystematic Risk** - Also known as "specific risk", this risk is specific to individual stocks and can be diversified away as you increase the number of stocks in your portfolio. It represents the component of a stock's return that is not correlated with general market moves.



## Diversification alone isn't enough



Source: Ibbotson Stocks, Bonds, Bills & Inflation Yearbook

- Because efficient frontiers change, fixed asset allocations can fail to reduce risk and volatility and leave investors vulnerable to market downturns.
- Passive asset allocation's use of correlation coefficients requires investment in asset classes that typically move inversely at different points in the market cycle. As a result, the portfolio will underperform the leading market indices in exchange for lower volatility.



## Minimizing losses matters



- It's harder to make up losses than most investors realize.

Mathematics of gains and losses

If the DECLINE is	It takes the following GAIN to break even
-25%	+33%
-33%	+50%
-50%	+100%
-75%	+300%
-90%	+900%

- Historically, the market has spent 66% of its time either in a declining market or making up losses.



## Compounded average vs. average



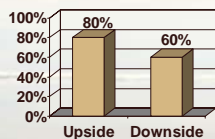
- A portfolio subject to the full volatility of the market tends to underperform a less volatile portfolio over time due to the mathematics of gains and losses.
- Limit your losses, and your portfolio will grow faster even at lower average annual returns.
- Active management looks at current market conditions rather than historical relationships to reduce volatility while seeking opportunistic investments to enhance return.

Average of the Years Vs. Compounded Average

	Case A	Case B	Case C	Case D	Case E	Case F
Year 1	5.0%	4.0%	9.0%	15.0%	25.0%	30.0%
Year 2	5.0%	5.0%	5.0%	-10.0%	15.0%	-25.0%
Year 3	5.0%	6.0%	1.0%	10.0%	5.0%	10.0%
Simple Average Return	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Compounded Average Return	5.0%	4.997%	4.949%	4.419%	3.714%	2.361%



## Capture ratio and downside impact



\$100,000 Initial Investment

	Year 1 Return	Year 2 Return	Ending Value
S&P 500 Index	+10%	-10%	\$99,000
Fund A	+8%	-4%	\$101,520
Fund B	+8%	+6%	\$114,480
Fund C	+8%	-8%	\$99,360

- **Upside Capture Ratio** = % of market return captured when market is up
- **Downside Capture Ratio** = % of market return captured when market is down
- **Downside Capture Ratio has more impact**



## Bull and Bear markets defined



- **BULL MARKET** - Movement in the stock market in which prices are rising and the consensus is that prices will continue upward.
  - Economic production is high
  - Jobs are plentiful
  - Inflation is low
- **BEAR MARKET** - Stock prices are falling and the consensus is that they will continue falling.
  - Economy slows down
  - Rise in unemployment and inflation



## Bear market realities



- Bear markets occur on average once every five years.
- Between 1929 and 2005 there were 19 bear markets.
- The average bear slashed portfolios by 30%.
- It took an average of 3.5 years to return to breakeven.
- Buy-and-hold investors spend 66% of the time they are invested in the market losing money in down markets and returning to the break-even point.
- The likelihood of financial damage from a bear market increases the longer you are invested. Time in the market does not lessen the risk of a bear market.
  - We insure against losses in other aspects of our lives from home and auto to personal liability.
  - Only in financial investments are individuals told there is nothing they can do to prevent losses other than diversification, which has its own costs.
  - At Capstone, we believe limiting losses is an essential element of good investment management.



## Flaws of traditional investing



If buy-and-hold investing increases risk, why do so many financial advisors use this form of investing?

Traditional investment management is based on the belief that markets are either:

- |              |            |                              |
|--------------|------------|------------------------------|
| 1. Random or | and either | 1. Impossible to predict or  |
| 2. Efficient |            | 2. Too efficient to outsmart |

These conflicting views are all incorrect. Numerous studies have demonstrated patterns in market behavior and inefficiencies that can be exploited for profit. Alternative investments, increased computing power, dramatically reduced trading costs and trading efficiencies, and more extensive, timely and readily available data have revolutionized investing for those willing to step outside the bounds of traditional investment management dogma.



## Capstone Investment Financial Group believes:



- The traditional methodology of buying and holding a diversified basket of stocks and bonds is well suited to a bull market similar to that which existed from 1982-1999.
- In the current market environment, the traditional approach is far too risky for the returns you can reasonably anticipate.
- Volatile markets offer opportunities to make money regardless of whether or not the overall trend of the market is up, flat or even declining.
- Successful managers in this environment are opportunistic and use active management strategies with the goal of absolute returns.
- Capstone seeks to craft portfolios that include both traditional and alternative investments and utilize skilled managers who seek to make you money regardless of how the traditional benchmarks perform.



## Two approaches to down markets



1. Use active management to avoid the decline.
2. Profit from the decline.
  - Arguments against active management tend to focus on the possibility that the investor would miss only the best days of the market.
  - Studies show that missing the best doesn't matter if you also miss the worst. In fact, missing both the best and the worst increases return with lower volatility.

Average Annual Return -- Missing the Best and Worst Days  
1/1/84 through 12/31/2007  
 S&P 500 Index Average Annual Return for period -- 9.83%

Missed # of Days	Miss the Best Days	Miss the Worst Days	Miss Best & Worst
10	7.43%	12.87%	10.56%
20	5.84%	14.64%	10.63%
30	4.37%	16.16%	10.60%
40	3.07%	17.53%	10.56%

Source: Analysis performed by Hepburn Capital Management, LLC



## There's room for imperfection



- Perfect "timing" according to Professor H. Nejat Seyhun of the University of Michigan would have turned a \$1 investment in a market index composed of a value-weighted index of NYSE, AMEX and Nasdaq stocks in January of 1926 into **\$690,000,000** by December 1993. In comparison, a \$1 buy-and-hold investment in the market index would have totaled **\$637.30** after the 67 years.
- Perfect timing is impossible.



Source: *Stock Market Extremes and Portfolio Performance*, a study commissioned by Towneley Capital Management and conducted by professor H. Nejat Seyhun, University of Michigan, 1994.

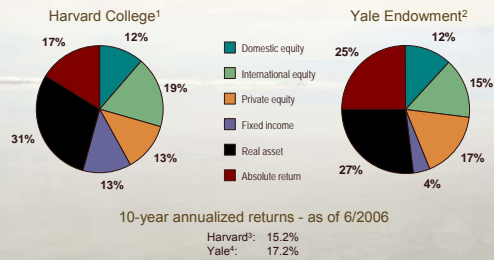
## Active management strategies



1. Use active allocation to position a portfolio in the strongest investment classes at the moment, rather than basing investment decisions on historical performance.
2. Apply quantitative analysis to avoid the majority of the market's declines and participate in the majority of the up movements.
3. Invest in leading investment styles or sectors of the financial markets during both up and down markets.
4. Use tools such as hedges, bear market funds and inverse funds to profit during declining markets.



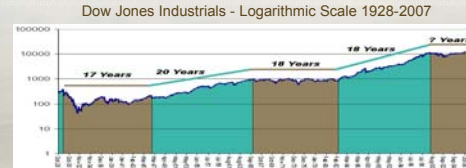
## Institutional Investors Use Alternative Investment Strategies



Past performance is no guarantee of future results. 1. Source: "Financial Report to the Board of Overseers of Harvard College," FY 2006-2008. Harvard's total exceeds 100% because of leverage. 2. Source: "The Yale Endowment 2006." Figures are target allocations as of June 2006; actual portfolio composition varies with market conditions. 3. Source: "Harvard Endowment Posts Solid Positive Return," Harvard Gazette Archives, 6/2006. 4. Source: "Endowment Skyrockets," Yale Daily News, 6/2006. This information is subject to change at any time, based on market and other conditions and should not be construed as a recommendation of any specific security or strategy. The above referenced report is created and maintained by independent third parties that are not affiliated with Capstone or any of its affiliates. Accordingly, Capstone and its affiliates expressly disclaim any responsibility for the content and the accuracy of the information presented, or the quality of the products and services provided therein. Although Capstone believes the information from these organizations is reliable, it cannot, and does not, guarantee or warrant the completeness or suitability of this information for any purpose.

## Markets move in cycles

- Although stock markets rise, they do so in fits and starts.
- Great bull and bear markets seem to approximate roughly 16 to 20 years.
- Following periods of overvaluation, markets can experience minimal gains for decades, trading sideways as earnings catch up with stock prices.
- Past performance should not be considered an indication of future returns.



Logarithmic scale allows gains to be viewed in relative percentage gains rather than absolute point gains.

Source: Dow Jones Industrials daily close - 10/1/1928 to January 2008.

## Successful investing requires structure

- The right investment strategy is the one that works with the investor's abilities, personality and knowledge.
- Successful investing requires a carefully considered plan of action based on market knowledge, non-emotional trading rules and the discipline to stick with the strategy.
- There is no perfect investment approach. All investment strategies will have unsuccessful trades.
- A successful strategy is one in which winning trades more than offset losses.

## Risk is a part of every investment

- All investments have the potential for loss as well as profit.
- An investment approach that sounds too good to be true generally is.
- The information provided here is intended to be general in nature and should not be construed as investment advice or as a recommendation of any specific fund, security or investment approach.
- **Too conservative of an investment approach could lead to your greatest risk -- running out of money in retirement.**

## Investment cautions

- No active management system is perfect. Every investment approach has the potential to lose money rather than making a profit.
- Even good systems will make investments that do not meet performance expectations and may lose money.
- Investment approaches often perform very differently at difficult points in the full market cycle.
- A successful investment approach is one where profitable trades outweigh the losers over time.
- Past performance may not be indicative of future performance. No current or prospective investor should assume that future performance results will be profitable or equal the past performance.
- We believe that the information contained herein to be accurate, but we cannot guarantee the accuracy of such information. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable.
- This document is not a substitute for personalized investment advice. Investors should consult with a financial advisor before investing.

## Use of Indices – Indices defined

This presentation uses a number of indices to explain and illustrate investment concepts. Indices are very useful in providing a means for individuals to verify the accuracy of statements made in this and other presentations. But their limitations need to be understood.

Index returns are for illustrative purposes only and do not represent actual performance of an account. Past performance does not guarantee future results. You cannot invest directly in an index. Index performance returns do not reflect any management fees, transaction costs or expenses, the incurrence of which would have the effect of decreasing indicated historical performance results.

- S&P 500 Index - Large Co. Index** - The aggregate market value of all shares of common stocks of 500 stocks from 83 industrial groups.
- NASDAQ Composite** - A measure of the aggregate performance of all NASDAQ National Market System stocks, except warrants, and all other NASDAQ domestic common stocks.
- Small Co. Index** - Performance of the Dimensional Fund Advisors Small Company Fund 1970-1978, Russell 2000 index thereafter.
- International Stocks** - Morgan Stanley Capital Markets EAFE (Europe, Australasia, Far East) index.
- Russell 2000 Index** - Capitalization-weighted index of domestic equities traded on the NYSE, AMEX and NASDAQ. The index represents the bottom 2000 from a universe of the 3000 largest stocks in the U.S.
- Emerging Markets** - Morgan Stanley Emerging Markets Index is a market capitalization index consisting of indices in 26 emerging economies: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.
- Treasury Bills** - Index of short-term U.S. gov't. bonds paying interest on money borrowed over a specific period of time.
- Government Intermediate Bond Index** - Index of all bonds covered by the Lehman Brothers Government Bond Index with maturities between one and 9.99 years.
- Government Long Term Bond Index** - Index of all bonds covered by the Lehman Brothers Government Bond Index with maturities of 10 years or greater.
- Long-Term Corporate Bonds** - Salomon Brothers Long-Term High Grade Corporate Bond Index - Corporate securities promising specific payments of interest and/or principal financed by a first claim on the issuer's earnings or assets.



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