



Where Capstone stands on the economic meltdown

As we look back at 2008 and forward to 2009, we are all faced with some difficult problems to solve. Where did we go wrong? Where did we do it right? Who can we trust going forward? What steps have you taken to help clients? What strategy should we have for our assets moving forward?

Where did we go wrong? We recently read where everyone involved in the Barron's Round Table (a panel of well respected financial experts) at the beginning of 2008 predicted that the market would close higher by the end of 2008. How could they be so wrong? The market closed the year off 37%, as measured by the S&P 500 Index! At Capstone, we went into the year with no bullish sentiment that the market would do particularly well; however, we had no particular reason to expect an unprecedented fall across the globe.

We did have reasons to be concerned about the US economy (too much debt, out of control personal spending financed through equity withdrawals through refinancing real estate, to name a few disturbing trends). As a result, we had a great proportion of portfolios weighted towards other assets, international investments, commodities, etc. Through July, that strategy was successful in reducing portfolio losses.

After July 1st, we saw a broad based global collapse of asset prices that was more severe than any during our lifetime. A barrel of oil fell over 70% in value. Gold and silver dropped due to decreased demand. Stock markets, real estate, and corporate bonds all dropped at a rapid rate. Virtually no asset class was spared; we have witnessed the end of the party and the close of an era. We do not expect that at the end of the day we will see things get "back to normal", as there is no "normal".

The era where many Americans buy things they can't pay for (i.e. both as individuals and collectively through our government) and don't worry about how or when we will pay for them is over. The devices that supported this party included using real estate as a piggy bank and using an enormous amount of leverage so that each dollar that was earned could be spent over and over again. We do not think that we will see a return to those days.

Where did we do it right? Perhaps the best thing we did throughout 2008 was to merely stay in the game rather than sticking our heads in the sand. Many clients (and advisors) were caught like deer in the headlights, sticking their heads in the sand as their response to the unprecedented downturn we experienced. We kept our eyes open and worked diligently on your behalf, trying our best to balance a need to get things done for you with a need to communicate with you and keep you in the loop.

Throughout the year, we monitored the markets and added value in many large and small ways. One way was to add a hedge in most fee based portfolios that consisted of a double reverse Dow fund. Through that portfolio addition we were able to reduce portfolio losses during the direst period of the year.

We have also looked at and implemented some trading strategies in eligible accounts, the main strategy would be writing covered calls on the domestic equity portion of our portfolios. This strategy takes advantage of all the volatility and uses covered call writing (i.e. selling someone the right to buy your stock at a certain price by a certain date) to produce immediate income. This new Capstone strategy requires a minimum portfolio size of \$250,000 to implement for existing clients. The reason for this is that we need to purchase the required stocks in round lots (i.e. lots of 100 shares each) and still keep the portfolio in an optimum balance you need at least that size portfolio. New clients will need either a minimum of \$500,000 (\$250,000 with a portfolio design fee of \$250). We believe this strategy offers an opportunity for truly exceptional returns in a difficult environment for investors.

Another area that has already shown value is the use of closed-end funds. We believe that purchasing these investments at large discounts can help you in three ways: it will increase the yield (interest and dividends) of your investments; it will open up the prospect of gains from the size of the discount narrowing; and you can also profit from the underlying assets (stocks, bonds, etc.) going back up in value. We consider this opportunistic strategy one that should help you immediately and help us in the longer term; the better you do, the better Capstone does.

Who can we trust going forward? First, we need to thank you for your support and trust during this crisis. We have in the past mentioned what an honor it is to be trusted with your precious personal wealth. So, we appreciate the trust and confidence our clients have shown throughout this difficult time.

In terms of our trust, we must come to grips with the fact that risk is unavoidable and that we cannot know where all risks lie despite our best efforts. What we are doing at Capstone, is trying to reduce and manage risk to increase overall performance over the years. There are steps that we have implemented and will continue to search out to keep risks as low as possible for you.

We provide our clients with full disclosure regarding our dealings and try to do business with firms that operate with transparency and disclosure. We put the bulk of assets into marketable, liquid investments that can be eliminated from portfolios if needed. We are leery of “sales” oriented firms and their presentations as they are the least likely to put client interests above their own. We believe in discipline rather than fashion - the best way to know what not to invest in is to see who is calling with their sales pitch about how well they have done. Following the last hot trend is never the way forward.

What steps have we taken to help clients? First, whenever possible we have made our fee-based custodian TD Ameritrade. We believe they help make us a more client centered firm, helping us eliminate custodial fees, increase our offerings of mutual funds that have no transaction fees, and lowering our trading costs.

We have parlayed those lower trading costs into strategies to try to improve client outcomes. While each trade we make costs us less at TD, we have invested literally thousands of dollars in the past several months in trying to improve your portfolio and its trajectory.

In particular, we have looked to add closed-end funds when they were available at large discounts to their daily net asset value. Purchasing these assets has cost us a great deal of short-term cash. However, we believe this was an investment for both of us and worth making for the long term.

We have made one other large commitment to improvement at Capstone. We have become an early adopter of Gravity Investment’s G-Sphere software program. We believe it is the finest and most sophisticated portfolio software on the market to help us evaluate true portfolio diversification and improving our allocations going forward. Essentially, the software will help show what true improvement adding an asset offers to the portfolio. For instance, if Asset A adds to portfolio diversification in the same manner as Asset B does but has a lower expected return, we would be better served to add Asset B to the portfolio and not add Asset A. We believe that we can use this software to improve our ability to show you what we are doing with your portfolio, but more importantly to help us with actually doing better management on a day-to-day basis.

What strategy do we have moving forward? As investment managers and investors we need to move forward with a clear understanding of potential risk and return and there are a couple of ways to view our economy as a whole and what course to take moving forward.

The first way to look at things and we certainly know of some people who simply can’t tolerate another down day for their portfolio. They may really need to be in an FDIC insured money market fund, treasury bills, or bank deposits. Over the long haul, they will have locked in the shrinkage that has already occurred in their

portfolio and will accept a growth rate, which will be unlikely to even keep up with inflation.

The other course of action is to see this as an opportunity to acquire assets at low prices and hold them until the economy recovers and they are no longer mispriced. In effect, you are trying to capitalize on the panic and fears of others. As fear and greed dominate investing, currently fear reigns and greed is tough to spot in current investor decisions.

Any asset with risk attached to it (basically everything except US Treasury Bills) has been ravaged by the market during 2008. Stocks, bond, real estate, commodities have all fallen at unprecedented speed. The challenge is to decide what assets will come back in value and when will they come back. There are many doomsayers out there who think the answer is never-our global economy will collapse and there will be no return.

We don't think that collapse is a likely outcome and believe instead that we will see a new economy with new rules, new leaders, and new themes emerge over time. We do not think that we will return to a global economy led by the US consumer, fueled by US borrowing and over-consumption. It will be a more balanced economy (until the next greed pushes us out of balance in some unforeseen new way). There will be new regulations fostering a more prudent consumer and attempting to limit Wall Street's use of leverage.

New themes that will drive the economy will include alternative energy and the "rise of the rest". Emerging markets will not only continue to grow and thrive, but will find much of that growth to be domestic growth rather than exporting products as the only driver of their success. This growth in emerging markets will also mean that commodities will return to being in demand and will begin to rise in price again.

The road will not be easy or without major bumps, but we believe that good times and good markets will continue to be a part of our future. We also believe alternative energy will be a primary economic driver moving forward and that global water management will continue to benefit from growth, climate change, and the development of emerging markets.

This gives us two types of opportunistic investments to try to utilize moving forward. The first is to allocate more money to investments that we believe are positioned well for the next several years. These would be the theme type investments-alternative energy, emerging markets, etc.

The second idea is to try to take advantage of what we feel are short-term mispricings of assets. These opportunities are likely to be shorter term ideas, lasting for about a year. As the assets become correctly priced, there will be no particular reason to add to these positions. The closed end funds are an example of this type of situation.

For 2009, we believe corporate bonds represent an opportunity to potentially earn equity like returns for the year. As the year goes along, riskier corporate bonds may begin to outperform if we can begin to stabilize our economy. So, we may add to our higher quality bonds first and later in the year add to our lower quality bond allocations.

The other short term opportunity we see is in the area of domestic stocks. We have already discussed the use of covered calls and how we believe this can improve the overall performance.

In short, we have been through possibly the worst period of time any of us will see in a lifetime. As always, we will have periods of growth and periods of decline. We are working our hardest to arrange your assets in a manner to help you achieve your goals and build for your future.

Please call to discuss your questions.

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