

THE 2000's

THE LOST DECADE OF RETURNS



“The Lost Decade”

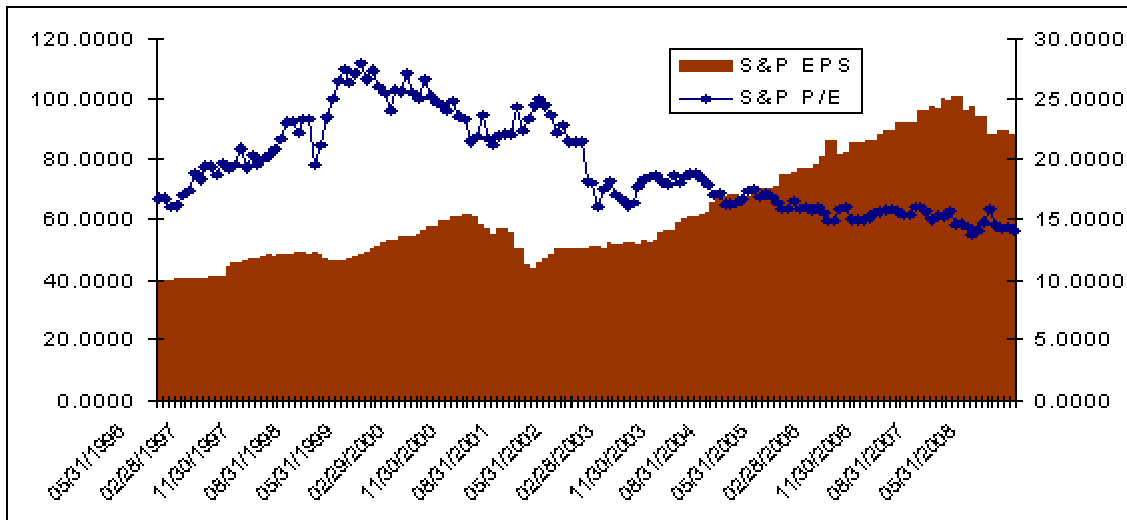
The year-long selloff in the stock market, initially sparked by the housing market meltdown and subsequent failures in the financial system, together with the global economic slowdown hides a more disturbing trend: i.e, the flight of investors from US Equities, in particular large capitalization stocks. This flight flies in the face of historical data and is prolonged by a decade-long absence of returns for only the second time in the past 100 years. This “lost decade” is only the third time in the past century that stocks have not kept up with inflation and only the second time that stocks have failed to show positive returns. However, reversion to the mean has been a powerful driver of returns following these below-average periods. Interestingly, the periods following these market downturns have produced outsized returns that have averaged almost 11% per year.

Don’t Be A Hero

The stocks we are presently asked about most frequently remain those that continue to headline the press and retreat the most. Bear Sterns, Fannie Mae, Freddie Mac, Lehman Brothers, AIG, etc. each sold off precipitously, which enticed investors with potential value. However, experience has taught us that a falling share price alone is not the measure of a more attractive stock. As these companies deal with the present uncertainty, their ability to repeat their historical performance comes further into question.

Figure 1 Source: Baseline, Cornerstone

S&P 500 Earnings versus S&P 500 Returns



How We Got Here

The sizeable earnings and productivity gains in the 1990’s were more than anticipated by investors, who then proceeded to price in perfection into the distant future. This “irrational exuberance” drove multiples to unsustainable heights. The result: a bursting bubble that has tainted investors, with most adopting the mantra “Once bitten, twice shy.” However, since the early 2000’s, corporate earnings have doubled, but earnings multiples have contracted by more than half (see Figure 1). Large cap equities, once the cornerstone of asset allocation, are now being used as a source of funds for new but

untested strategies as investors search for positive returns. Despite impressive back tested returns, hedge funds and 130/30 strategies are no substitute for large caps. They in fact lie at the heart of much of the financial unwinding because of the leverage employed. Hedge funds initially started as a way to take advantage of small arbitrage opportunities, but they are now synonymous with short selling and heavy leverage.

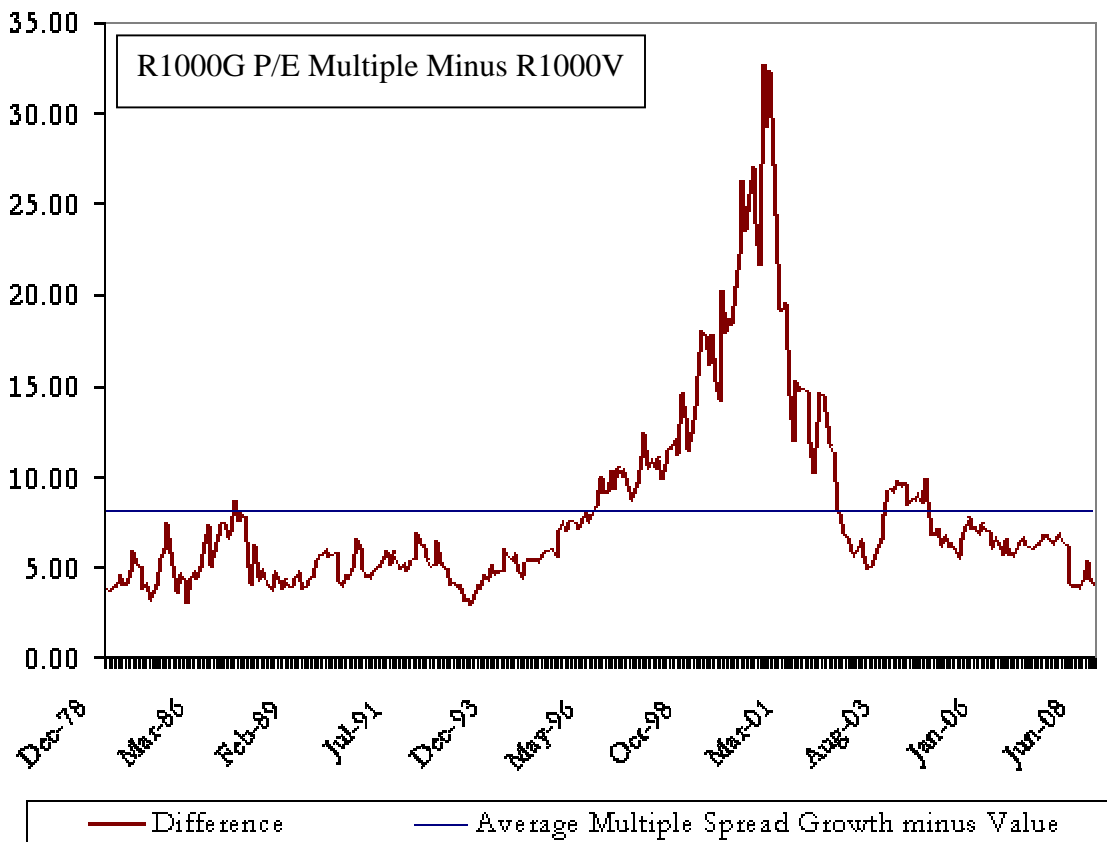
In the first quarter of 2008, liquidations of hedge funds climbed 20%, with fewer funds launched and 170 funds closing. This was an increase of roughly 30% over the year-earlier period. Since then, the situation has worsened in a sector that sees 5% to 10% of its participants shutting their doors on an annual basis.

The Case For Core

Rotation between value and growth seems to be a constant exercise for investors. Value has historically provided superior returns, but when growth is in favor, high returns can be generated in quick fashion. The discrepancy in valuation is usually significant due to the discrepancy in growth prospects (see Figure 2). However, as growth has slowed, the difference in P/E multiples between growth and value remains near historical lows. Despite this, Cornerstone believes market timing is a fruitless exercise. Cornerstone believes value and growth are not classifications, but rather conditions ultimately create opportunities.

Figure 2 Source: Baseline, Cornerstone

AVERAGE MULTIPLE DIFFERENCE BETWEEN GROWTH AND VALUE

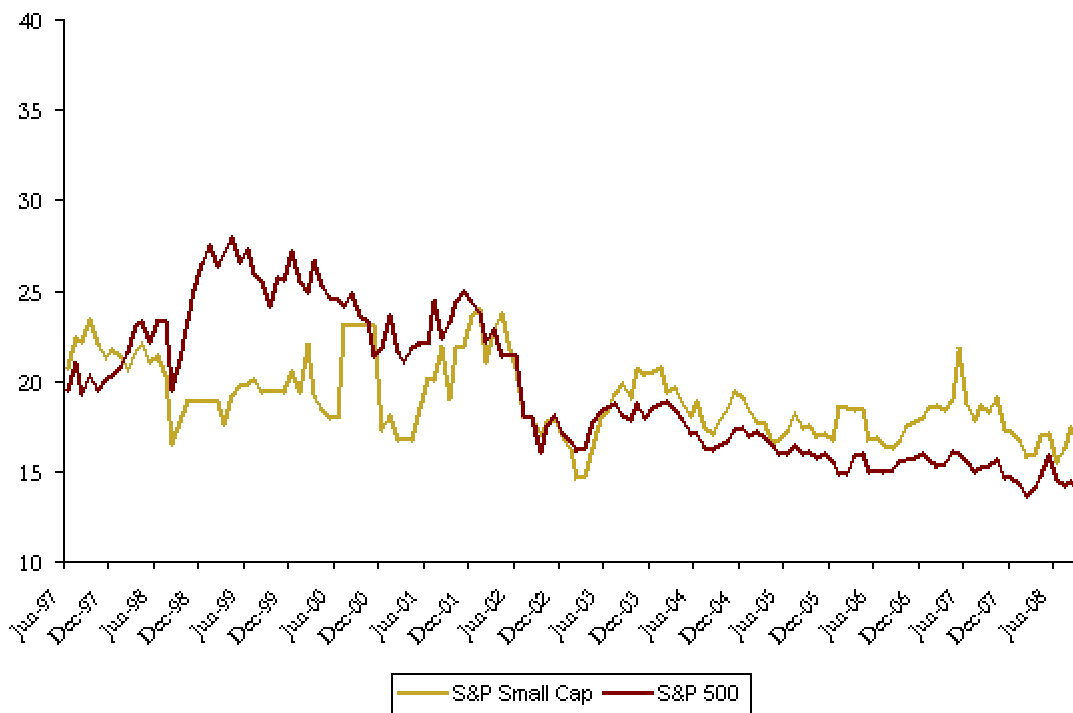


Does Size Matter?

Small cap stocks have also garnered much of the attention of the research community, as a stealth bull market began when the bubble burst on large caps in the late 1990's. Small caps are typically defined as those stocks below \$1 billion in market capitalization; large cap stocks have market caps north of \$10 billion. While at first glance, small caps have provided higher returns historically (12.2% versus 10% for large caps since 1927), that reputation has been generated by two cycles of domination - one from 1973-1983, the other, from 2001-present. Large caps have typically offered better risk-adjusted returns. Small companies also have historically been a riskier investment because they typically have less proven track records, more reliance on outside sources for financing the business and more concentrated businesses.

Figure Error! Bookmark not defined.3 Source:Baseline,Cornerstone

Small Cap Versus Large Cap P/Es Over Time



Due to this inherent riskiness, the price-to-earnings multiples of small cap stocks traditionally have traded at discounts to their large cap peers, but since 2003, those discounts have reversed to premiums (see Figure 3). Given the inherent economies-of-scale, global presence, ability to attract top management and to finance themselves through their cash flows and their current valuation discrepancy, large caps look increasingly attractive.

Commodities?

Commodities have become increasingly popular as investors look for non-correlated ways to help achieve investment goals. Attention has also been brought to this space by the significant rise in prices over the past few years (see Figure 4a) as The CRB Index is up more than 50% in the past five years, and 71% since the beginning of the decade. Commodities in some instances have more than doubled. Oil is up 266%; corn, 161% and gold, 161% since the beginning of the decade as investors anxiously bid up prices in anticipation of spiking global demand. Alas, we have seen that as demand in the US has slowed, so have global economies, which has placed downward pressure on all commodities. However, from 1988-2003, returns were essentially flat for the commodities index (see Figure 4b) despite two decades worth of worldwide economic expansion.

Figure 4a (Source:Baseline,Cornerstone)

CRB Index Price Movement

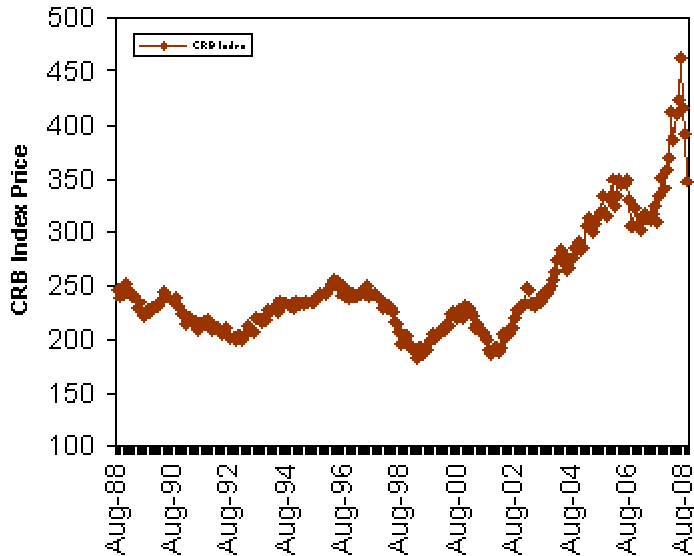
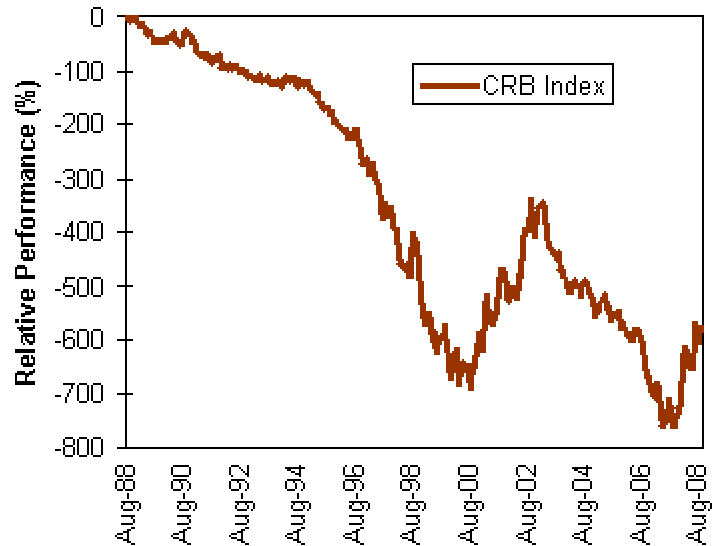


Figure 4b (Source:Baseline,Cornerstone)

CRB Index Performance Relative to the S&P 500



Investor fear has also led to an historic amount of cash moving to the sidelines as money flows out of US equities. The past two years are the first time we have seen net outflows in US equity mutual fund flows in successive years for as long as data is available (see Figure 5) and the first negative flow period since 2002. There is also a tremendous amount of cash (nearly 28% of the Wilshire 5000) sitting on the sidelines in money market funds, a total not seen since the market lows of 2003 (see Figure 6).

Figure 5 (Source:ICI, Citigroup)

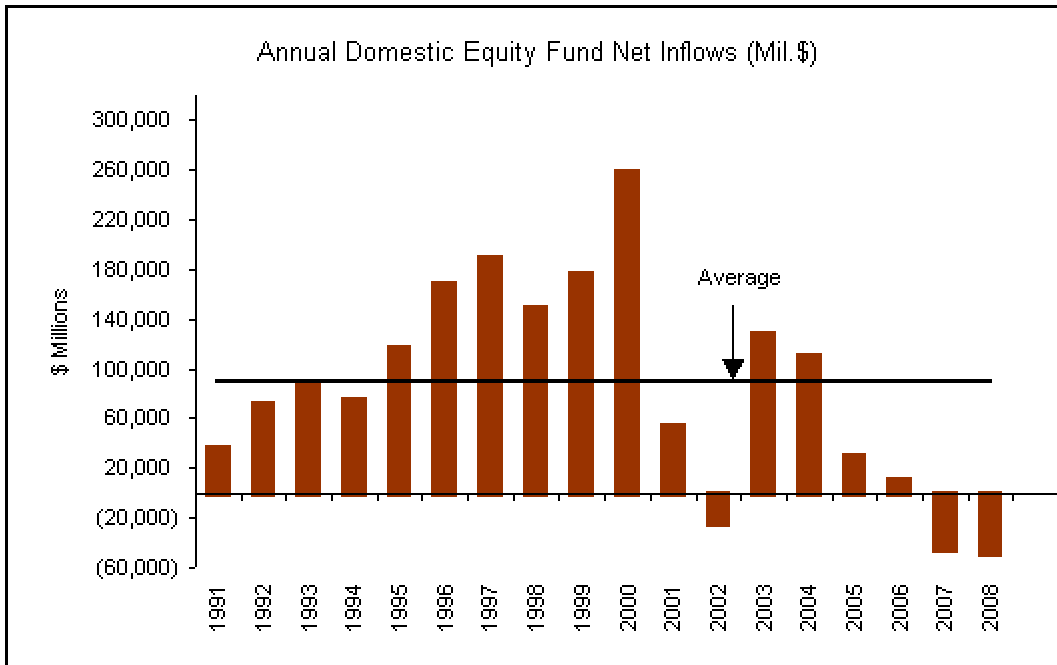
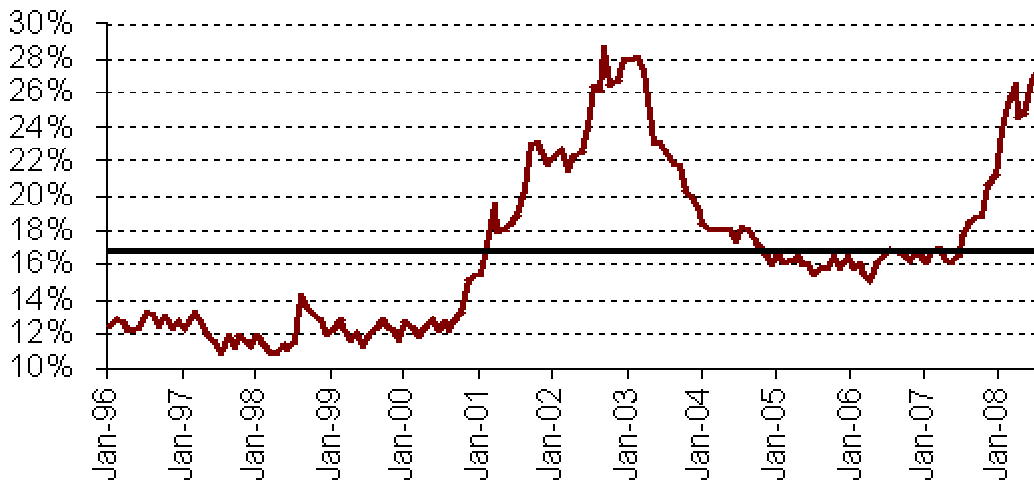


Figure 6 (Source:ICI, Citigroup)

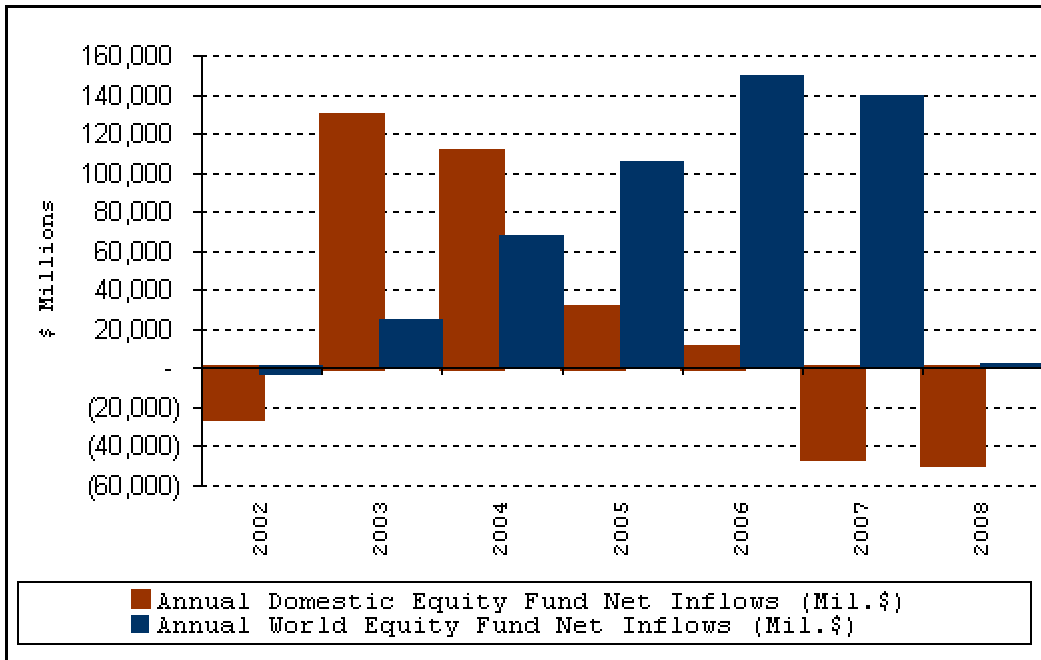
Money Market Fund Assets as % of Wilshire 5000



Of note, the five years following this peak in cash led to S&P 500 returns totaling 88%. This increase has been offset by record inflows to sectors that have enjoyed peak performance during the past few years, including international and emerging markets (see Figure 7).

Figure 7

International Funds Benefiting From US Equity Outflows

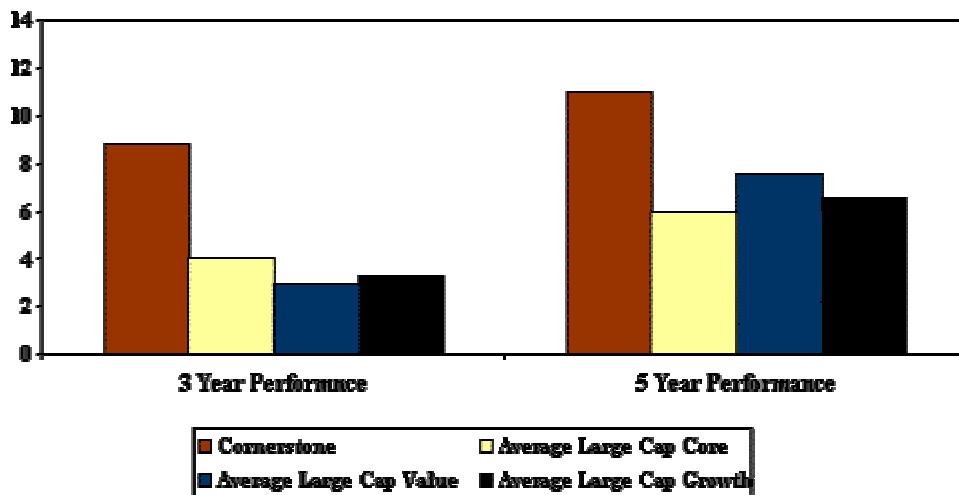


(Source:ICI, Citigroup)

Regardless of which asset class is currently in favor, Cornerstone has outperformed value, growth and core benchmarks over time as well as 95% of managers in the large cap space, regardless of style bias (see Figure 8).

Figure 8 (Source:LCG Associates, Cornerstone)

Cornerstone Versus All Large Cap Styles



The Final Word

Large cap companies have largely been shunned throughout the 2000s as multiples were being corrected and lessons were being learned. However, as with most market reactions, the pendulum which had swung too much in their favor, has now overly punished them and left companies trading at valuations not seen in 20 years. Interest rates remain at very low levels, a fact which creates two large tail winds for large cap stocks when the market works through any of its current issues. Disciplined and long-term-focused investors have an opportunity to achieve above average returns by taking advantage of the rampant emotion inherent in the market. Cornerstone will continue to avoid changing with every new wind and will not limit our thinking to style-box concerns. Looking past the anxiousness, Cornerstone sees a relatively attractive market combined with low interest rates and even lower expectations and this is a recipe for successful investing.

