



8053 XERXES AV S. ■ BLOOMINGTON, MN 55431 ■ 952.926-3000 ■ Toll Free: 866.926.3022 ■ www.capstratcorp.com ■ e-mail: capstrat@comcast.net

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CSFC Investment Strategy and Philosophy

There are times when financial market conditions are volatile and uncertain, and it is very easy to find one's self buffeted by swings in the market prices and market sentiment. It is during these times especially that it is important to be grounded in a core philosophy, such that you never lose sight of the big picture. When the financial media get overly excited and focus on interesting but ultimately short-term events, it is easy to have one's perspective knocked off balance. This is why we have to periodically take time to remind ourselves and our clients of our core investment philosophy.

The Capital Strategies investment philosophy is to protect our clients' principal. Simply put, we want to avoid losing money. If we interpreted that to mean never suffering a down day, we could put all of our investment funds into T-Bills. That is not what we mean. We are interested in protecting principal and purchasing power, (inflation) over the long-term. This means we must earn a long-term rate of return that is positive when adjusted for taxes and inflation. This forces us to purchase securities that we know will fluctuate in value. We also know that fixed rate securities (bonds) very seldom offer positive returns on an after-tax and after-inflation long-term basis.

Protecting principal means you do not subject as much of your portfolio to market risk when conditions are not favorable. Unfavorable market conditions include rising interest rates, high valuations, exuberant investor sentiment, declining liquidity, and deteriorating economic conditions. Note that this list does not include falling stock prices. If stock prices fall in the absence of any of the conditions listed above, we would be more inclined to increase our exposure to the stock market.

Some argue that a long-term investor should never change their investment mix relative to what is going on in the market at any given time. We believe in a different approach. Arithmetically, losses become exponentially more difficult to gain back and to break even. For example, if a portfolio loses 5% it must earn 5.26% to get back to even. If it loses twice that much (10%) it must earn 11.11% (an additional 1.11%) to break even. A 20% loss requires a 25% gain (5% extra) to get whole. In a worst case scenario, if an investor were to lose 50%, their portfolio has to double in order to break even. Even though you may think this is highly unlikely, we would remind you that between March 24, 2000 and October 7, 2002 the S&P 500 lost close to 48%. It took almost five years for the market to gain back the necessary 92% to make those investors whole, and soon thereafter stocks began a 17% decline that has taken us to where we are today.

The moral of the story is that it is far preferable to avoid the serious losses in the first place than to try to recover them. However, loss avoidance is not always easy. Usually it requires being defensive when stocks are still in an uptrend. It also requires patience in terms of both waiting for investors to realize conditions have deteriorated, and then once stocks have fallen, waiting for conditions to improve enough to warrant purchasing stocks.

Lower prices are not in and of themselves a good reason to buy. Financial shares lost a third of their value between June 2007 and March 2008. Since then they have lost an additional 17%. Trying to guess when a sector is going to hit the bottom is like trying to catch a falling knife and certainly not consistent with the objective of protecting one's principal.

It is easy to talk about avoiding risk. So how do we know when to buy? We look for the unfavorable conditions mentioned above to have reversed their course. We are also looking for low or modestly declining interest rates (rapidly declining rates indicate economic crisis), improving liquidity conditions, negative investor sentiment, reasonable to cheap stock prices, and economic stability. We are willing to wait for the right market conditions because by then we will have taken a lot of the long-term risk out of the equation. In the short-term however prices can and often do fluctuate wildly.

In summary, Capital Strategies has an overriding responsibility to protect our clients' principal on a long-term basis. In order to do this, we try to dispassionately assess financial market conditions and make allocation decisions based upon those these assessments. Until financial market conditions change for the better we will have the patience, as we hope you will, to maintain our core investment approach.

Capital Strategies Financial Corporation
Mark A. Carlton, CFA Eric C. Graber, President