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CSFC MUTUAL FUND SELECTION PROCESS

We manage our mutual fund portfolios primarily from a risk standpoint. In other words, we think first about what we might lose, as opposed to what we might gain. Index funds address the issue of gain, because you are assured of doing no worse than the market (less fund expenses, or course). However, the market on occasion produces returns that an investor might not find acceptable. The S&P 500 lost 49% between March 24, 2000 and October 8, 2002, for example. This kind of a loss on blue chip securities was quite surprising to most investors, though hardly without precedent (1929-32, 1937-38, and 1973-74). So in order to put together portfolios that do not disappoint investors (or worse, cause them to abandon the equity markets altogether), we employ greater diversification. We use bonds, cash, international stocks, and various “hard assets” including real estate in order that a portfolio will not suffer a loss greater than an investors’ ability to endure without selling.

It is possible, of course, to construct a portfolio completely out of index funds. One could diversify by using a large cap stock index fund, a small cap index stock fund, a bond index fund, etc. If markets were efficient, this would actually be a preferable way to manage money. It is our belief that markets are far from efficient, in most cases. Investors have different time horizons, different access to information, different biases and different temperaments, among other things. We have witnessed investor behavior that made no sense from a financial standpoint. Theoretically, if there are those who consistently make bad decisions and thereby suffer returns worse than the market, there must also be those who make more than their share of good decisions, and whose returns are therefore better than the market. In practice, we have found this to be true.

Where markets tend to be the most statistically inefficient (international and small company stocks), there is the greatest opportunity to add value. As a result, we are more likely to use an index fund in the large company part of the portfolio than anywhere else.

We do a thorough analysis of each fund that we believe has the potential to perform better than the index, taking into account how the fund has performed in both up and down markets, the percentage of the time the fund was a superior performer (we don’t want a fund that make one spectacular market call), the conditions (size of fund & manager) that were in place when the fund outperformed, and the element(s) that we believe make that manager able to deliver consistently superior results.

The key is really the capture ratio, or the performance of a fund relative to a benchmark in an up market versus its performance relative to the benchmark in a down market.

Capture ratio is a useful measure of whether a fund is worth owning (adds value) as opposed to an index fund, but it is even more significant if you can calculate a portfolio's capture ratio. If we combine several different funds each with positive capture ratios into a portfolio, we believe we will do well relative to the market. Of course, care needs to be taken in terms of how much of each fund to use – the greater degree of your comfort which regard to a funds relative and absolute performance, the more of it you will use. Finally, it is very important that the portfolio be carefully monitored because capture ratio is dynamic, not static. Changes will be made because of economic events, valuation, and adverse performance of components of the portfolio.

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