CAPSTONE PACIFIC
INVESTMENT STRATEGIES INC

Frequently Asked Questions

1. What about buy and hold? Doesn't "Modern Portfolio Theory" prove that buying and holding investments is the best way to invest?

Actually, no. "Modern Portfolio Theory" is based on the work of Harry Markowitz who won the Nobel Peace prize in 1989 for his work on mathematical formulas for diversifying portfolios—Markowitz's research was not about "buying and holding". We believe buy and hold is a misapplication of Harry Markowitz's "modern portfolio theory" which has become a leading premise for investor advice today. In a 2010 interview Markowitz himself disagreed with the buy and hold application of his theory when he said "I've never been a buy and hold guy," and "modern portfolio theory" has been misapplied into naively staying the course when deeper analysis is warranted. There are times, he said, when portfolios should be adjusted if risks appear outside the norm.[1] This is why we do not feel compelled to be fully invested in stocks, or any asset class, when an alternative investment (such as cash reserves for example) offers a more attractive opportunity. Our suspicion is "buy and hold" has more to do with the conflicts of interest that exist between Wall Street investment firms, analysts and the companies they represent. It is more profitable for companies to have their clients invested than it is to be in cash. We think this is why the former SEC Chairman Arthur Levitt said there is a "buy side bias" on Wall Street.[2]

2. Do you do fundamental research? Or is your approach mostly price based trend analysis?

We do both. Fundamental research helps us to know what to invest in, while trend (technical) analysis helps us determine when to invest.

Studies show that using one particular strategy or factor is not as optimal as combining factors.[3] A multifactor approach is better because the market tends to punish certain factors while rewarding others. We combine strategies and factors in a way we think will help provide a more stable and consistent growth of investments.

In addition, we feel it is increasingly important to use technical analysis in our work because the financial statements analyzed by fundamental analysts are not objective but are the result of numerous estimates and assumptions that have been added together to arrive at the line items in the financial statements. We believe price data in technical analysis is objective because there is no arguing with the price of a security. Though judgment is still required in how price trends are analyzed.

[1] "'Buy, hold' investing often misapplied into staying course", Gail MarksJarvis, *Chicago Tribune*, January 31, 2010.
[2] "Point of View: Analysis Through Rose-Colored Glasses", *Wall Street Journal*, October 21, 1999.
[3] *What Works on Wall Street*, James O'Shaughnessy, pg. 653.

3. What is the evidence that supports your approach?

In his book, *What Works on Wall Street*, James O'Shaughnessy examines a wide range of investment strategies and tested them over extensive periods of time and market conditions. What he found is that momentum, or trend based relative strength investing, is one of the more consistent factors over time. According to O'Shaughnessy, "Relative strength is among the only pure growth factors that actually beats the markets consistently and by a wide margin" (pg 443). In addition he found that, "Each of the ten-best performing strategies…includes relative strength" (pg 594).

This is one reason why we rely so heavily on supply and demand because it captures the relative strength of investments. And because of the evidence of combining factors as a more optimal approach (see question #2 above) we use it in conjunction with other factors.

4. What about using Morningstar Ratings® to make investment decisions?

Research has found this might be one of the worst ways to invest. *What's a five star fund worth? Not much suggests Baird*.[4] Baird looked at the performance of mutual funds between 2005 and 2013 and examined how 5 star funds performed over various 3 year periods. What they found was a high Morningstar rating probably leads to future underperformance while low rated funds tended to outperform the higher rated funds going forward.

5. Are there any downsides to your approach utilizing momentum strategies?

According to O'Shaughnessy's study, "The only time that strong price momentum leads you astray is at the peak of a bubble or when the market is emerging from a severe bear market (pg 419). He points out though that, "Typically this inversion is a short-term event and usually lasts only about a year. We then see things return to normal, with the best price performers vastly outdistancing all other stocks" (pg 420). This is why we use momentum in conjunction with other strategies, to try to off-set the impact of extreme market conditions on a momentum strategy.

In addition, our experience is that markets can go through less severe downturns yet still be in a positive demand trend, like with the downturn in the Fall of 2011 when the S&P 500 fell over 18%.[5] At that time the demand for stocks overall was still strong, even though the markets were falling for the time being. This is why we think strategies still need human input. You can't rely blindly on any indicator or process, and that it takes insight, perspective and teamwork to assess and act upon indicators. Even though the markets fell rather substantially in the fall of 2011, the overall demand proved correct as the S&P 500

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[4] "What's a Five-Star Fund Worth? Baird Study Suggests Not Much" *Barrons,* March 21, 2014
[5] *Yahoo Finance*

has rallied over 80% since bottoming out in October 2011.[6] An analogy we like to use is that cutting edge research is kind of like high end formula race cars. Research is the car that's built and maintained by teams of very skilled technicians. But the technicians can't actually drive the car. It takes a highly specialized person to make the car perform. That's where we come in. Though it's not possible to catch the exact tops or bottoms of investing. There is no red light telling us when to sell or green light telling us when to buy. By using our cutting edge research to catch the major part of a trend we believe we can help our clients accounts perform without undue risk.

6. What about diversification? Your approach seems to focus on certain sectors and investments while ignoring others.

Warren Buffett has said diversification is for investors who don't know what they are doing.[7] While we do believe it makes sense, especially for fiduciaries, to not put all their eggs in one basket, we also think one of the keys to achieving investment performance is to either focus on investments or sectors that appear to be in demand and avoid investments or sectors that do not appear to be in demand.

7. Who is Capstone Pacific Investment Strategies, Inc. and what makes you so smart?

Capstone Pacific Investment Strategies, Inc. is a registered investment advisor free from the conflicts of interests that interferes with objective advice.[8] We are an independent firm with over 50 years of combined experience between our advisors. We have managed money while at one of the larger financial companies in the world as well as with smaller broker/dealers. In 2011 we took the next step in independence and launched Capstone Pacific, a privately owned and independent investment management firm. In addition to our experience, we are part of an exclusive national network of leading advisors, from the large institutions to the independents like us.[9] Unlike most advisors who don't tend to share with others, this is a unique network that readily distributes ideas that work successfully with others in the network. As far as our investment management research, not only do we roll up our sleeves on a daily basis and dig into the research, we receive advanced training and mentoring from top advisors and investment managers.[10] When you put together our experience, research and training, our clients get the best of both worlds, the efficiencies of a smaller firm with the expertise, training, skills and research of the larger institutions.

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[6] *Yahoo Finance*
[7] "The Dangers of Overdiversifying your Portfolio", *Investopedia*, February 10, 2010.
[8] Registration does not constitute an endorsement of the firm by securities regulators nor does it indicate that the adviser has attained a particular level of skill or ability.
[9] Bill Good Marketing
[10] No More Pies, 1/2012, 3/2012, 12/2013

8. Why Relative Strength?

Over time relative strength has proven to be a driving factor in outperformance. A study conducted by O'Shaughnessy in *What Works on Wall Street* found that "*A $10,000 investment on December 31, 1926, in the decile of stocks from All Stocks with the best six-month price appreciation is worth $572,831,563 at the end of 2009,* ***a compound return of 14.11 percent a year****. This return dwarfed an investment in the All Stock universe, which turned $10,000 into $38,542,780 over the same period,* ***an average annual compound return of 10.46 percent*** (emphasis ours)*.*" It is also important to point out that O'Shaughnessy found that this relative strength portfolio outperformed the benchmark in 68% of single-year returns, 79% of rolling 3-year returns, 87% of rolling 5-year returns, 95% of rolling 7-year returns, and 98% of rolling 10-year returns. Also, keep in mind that this is just a generic relative strength strategy based on a 6-month return factor with annual rebalances. His book also showed that using a 12-month relative strength factor also outperformed the benchmark with a compound return of 12.34 percent. And, just in case you were wondering, a strategy based on buying stocks with the worst 6-month returns and then holding for a year had an annualized return of 4.15 percent! As stated in the book, *"If you're looking for a great way to underperform the market, look no further (than buying relative strength laggards)."*

It is necessary to monitor relative strength trends and make changes when warranted.

9. This seems like a relatively new way to invest, is there any other research being done on this approach?

Technical analysis is probably one of the oldest investment strategies because prior to 1934, with the Securities and Exchange Act, public companies were not required to regularly file financial statements that were available to the public. In fact, Point and Figure Charting was invented by Charles Dow, the first editor of the *Wall Street Journal*, in the 1890s.[11] As for research that is currently being done to substantiate this approach:

Documented Relative Strength Research

Fact, Fiction and Momentum Investing, Israel, Frazzini, Moskowitz, and Asness, 05.09.14

Asymmetric Risks of Momentum Strategies, Victoria Dobrynskaya, 03.26.14

The Trend is Our Friend: Risk Parity, Momentum and Trend Following in Global Asset Allocation, Andrew Clare, James Seaton, Peter Smith, Steve Thomas,02.03.14

Momentum: Style's Third Domain or a Replacement for Growth, Myles Zyblock, CFA et. al.,11.20.12

Risk Adjusted Momentum: A Superior Approach to Momentum Investing, Rasool Shaik, CFA., 12.07.11

[11] *CFA Textbook* 1, 2011

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Momentum - A Contrarian Case for Following the Herd, Tom Hancock, 09.20.10

Momentum Investing, Tobias J. Moskowitz, PhD *Investments & Wealth Monitor*, IMCA, reprint with permission from IMCA only, 08.16.10

Relative Strength Strategies for Investing, Mebane T. Faber, 04.20.10

The Case for Momentum Investing, Adam L. Berger, Ronen Israel, and Tobias J. Moskowitz, 07.22.09

Value and Momentum Everywhere, Clifford S. Asness, Tobias J. Moskowitz, and Lasse H. Pedersen, 07.10.09

A Quantitative Approach to Tactical Asset Allocation, Mebane T. Faber, 05.20.09

The Capitalism Distribution, Blackstar Funds, 12.05.08

Point and Figure Special Report, Dorsey Wright Money Management 10.01.08

Using Style Momentum to Generate Alpha, Tibbs, Eakins, and DeShurko (Courtesy of the Market Technicians Association), 06.04.08

Powershares Technical Fund Delivers on Promise, Roger Nusbaum, 04.25.08

108 Year RS Research, ABN-AMRO, 02.27.08

A Flexible Theory of Price Momentum, John Brush, 06.14.07

Value and Growth, Theory and Practice, John Brush, 06.14.07

Failure Factors, John Brush, 06.14.07

Price Momentum, John Brush, 06.14.07

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MTA Newsletter, Bob Farrell, 06.14.07

A Test of Relative Stock Values Reported over 17 1/2 Years, Charles D. Kirkpatrick II, 06.14.07

Returns to Buying Winners and Selling Losers, Narasimhan Jegadeesh and Sheridan Titman, 06.14.07

Style Momentum, Hsiu-Lang, 06.14.07