

THE PINNACLE INVESTMENT METHOD

PINNACLE
ADVISORY GROUP, INC. 



STATUS QUO INVESTING IS BROKEN

With few exceptions, the financial community practices “Buy and Hold” investing. In short, Buy and Hold investing is based on the belief that while the market will go up and down in the short term, over the long term — five years or more — it will rise at a relatively predictable rate. So in periods of economic upheaval, investors are told to be patient and wait out the storm, and not “panic” and rearrange their portfolios.

This confidence in an ever-rising market forms the foundation of the mainstream approach to portfolio construction. Investors are taught to decide how much risk they’re willing to take — greater risk offers higher potential returns, but also an increased chance of losing your money if things go wrong in the short term. Once investors settle on the level of risk they’re comfortable with and what time frame they have, they’ll then know how best to divide their investments. For example, if they need their money in four years and would rather have lower but more reliable returns, they might go with a conservative portfolio made up of 70% bonds and only 30% stocks.

According to Buy and Hold investing, each time frame and level of risk has its own ideal asset ratio. And because Buy and Holders believe the market grows at reliable, historical rates, investors can depend on receiving the returns they were promised when they first created their portfolios.

Unfortunately, things haven’t worked out that way.

If you had entrusted your nest egg to the S&P 500 on January 1, 2000, expecting a historical annual return of 11%, you’d be in for an unhappy surprise: By December 31, 2010, your investment would have grown a paltry 4.25% in total returns, 0.38% per annum, which includes reinvested dividends. Once you calculate in 3% inflation per annum, you would have actually *lost* ground. That’s no way to save for the future.

Worse off still are those Americans who retired in the late 1990’s, expecting that their balanced portfolio would deliver its historical average return of about 8%. For those who either invested in a balanced portfolio of stocks and bonds on their own, or who relied on the counsel of professional financial advisors, and who have subsequently withdrawn their money in order to maintain their standard of living in retirement, the resulting decade of less than expected portfolio performance has been potentially catastrophic. Some elderly retirees have been forced to either reduce their standard of living, or go back to work.

So why did this happen? It certainly wasn’t through the neglect or bad-intentions of mainstream investment advisors. They were simply following the theories and methods they were taught.

A Theory in Crisis

Modern finance uses past data to build mathematical models that tell us how to best construct portfolios out of multiple asset classes. The most famous of these models is the Nobel Prize-winning Modern Portfolio Theory, which uses past returns, correlations, and volatility to determine the most efficient mix of asset classes to get the highest returns for any given level of risk. In most cases, the more asset classes that are available, the more efficient the model portfolio becomes. This leads to the conclusion that diversifying a portfolio reduces risk, and that by diversifying with asset classes that have high returns but low correlations to each other, you can increase the total returns. For the past forty years diversification has been the most important element in portfolio construction.

The problem with Modern Portfolio Theory is that the resulting portfolio is only as efficient as the predictions for returns, volatility, and correlations that go into it.

Future returns can vary widely from expected average historical returns for long periods of time, and volatility has soared with the advent of hedge funds and high frequency trading. Furthermore, correlations between asset classes increased as the world 'flattened,' with traders able to take part instantly in any market around the globe. This has undercut the presumed benefits of low correlation, and has resulted in higher portfolio risk.

As a result, over the past decade portfolios designed with traditional asset classes -- and by traditional methods -- have dramatically underperformed expectations, creating havoc in personal financial plans.

Wall Street to the "Rescue"

Wall Street has known about the problems with Buy and Hold investing for many years. In response, they developed a new investment style that would "hedge" the results of those portfolios that depended on the markets delivering expected historical returns. That's how hedge funds and "alternative investments" came to be.

Hedge funds, as the name implies, are designed to hedge the performance of a traditional portfolio by using strategies that are not dependent on the markets. Long-short, market neutral, convertible arbitrage, event driven, global macro, market timing, and other hedge strategies offer the promise of making money even when financial markets are not. Alternative investments, like private equity pools and managed future funds, are intended to do the same thing. It's not uncommon for hedge funds and alternative invest-

ments to make up 20%-30% of today's most sophisticated portfolios. Unfortunately, both suffer from a serious weakness: They often rely on managers to execute those strategies. Modern behavioral finance tells us that money managers are subject to biases and heuristics that can lead to poor decision making. Being human, they're vulnerable to the crowd mentality and can succumb to panic buying and selling. Not only that, but those strategies tend to be inconsistent in their effectiveness — in other words, "they work until they don't work." In many instances, the markets 'catch on' to whatever strategy is currently working, and arbitrage away the excess returns. Managers who dogmatically follow one approach can make large bets with investors' money that result in catastrophic, unexpected losses. If you've followed the financial news over the past ten years, you've seen plenty examples of that.



THE PINNACLE SOLUTION

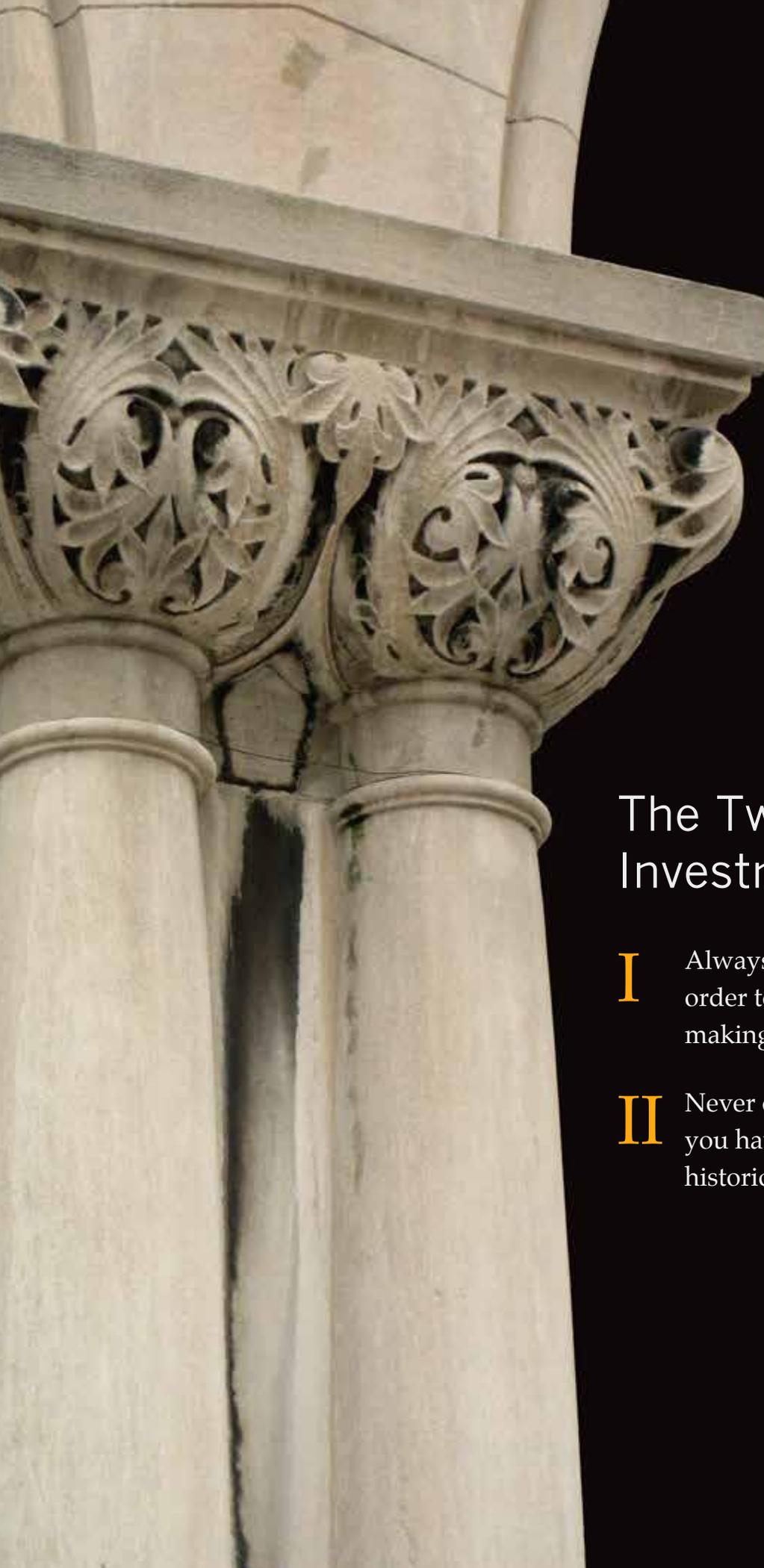
Neither the traditional Buy and Hold approach nor the risky methods of hedge funds and alternative investments are ideal. What is needed is a strategy that utilizes the strongest ideas of both. At Pinnacle, we believe we've achieved that best-of-both-worlds approach by combining the portfolio diversification of traditional investing with active management.

While status quo advisors agree that portfolios should be diversified — it's the investment equivalent of not putting all your eggs in one basket — they reject the idea that portfolios should also be actively managed. Because of their near-religious belief that markets will eventually deliver the returns that they have in the past, they tell their clients to "be patient" and wait out any market turmoil (even when it lasts over ten years).

We disagree. Instead of sitting on our hands and hoping the market will eventually deliver the returns our clients need, we respond to changing economic and

market conditions by modifying our portfolio asset allocations accordingly — first, to minimize any risk to their assets, and second, to take advantage of opportunities to increase their returns. This is different from what is usually meant by "active management" — generally understood as the choice to forgo passive index funds in owning asset classes in favor of managed mutual funds in owning those same classes.

While everyone else is focused on how to manage an individual asset class, we at Pinnacle are interested in managing the *entire* portfolio of asset classes. Instead of Buying and Holding a fixed allocation of asset classes, as taught by Modern Portfolio Theory, we change the asset allocation of our portfolios in line with our changing view of market opportunities and value.



The Two Pillars of Our Investment Philosophy

- I** Always own a diversified portfolio in order to minimize the chance of making a major investment mistake.
- II** Never own overvalued assets where you have little possibility of earning historical average returns.

How We Manage Risk

The freedom to reshape the asset allocation of a portfolio changes how risk is typically managed. The traditional method involves choosing a benchmark for the portfolio that has a well-defined allocation to risky assets -- typically stocks, commodities, and real estate. By pre-setting the target, the manager can forecast portfolio returns and volatility based on the past performance of those risk markets. In theory, as long as the manager owns the target asset allocation, the client can use past results to plan for future returns. We believe recent history has shown the great danger of this approach.

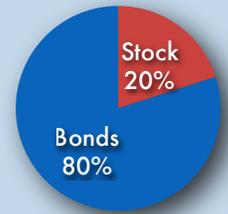
At Pinnacle, we don't constrain ourselves by a set mix of assets in our portfolio benchmarks. Rather, we target a specific level of volatility for each of our portfolio strategies, regardless of which asset classes they happen to include. Our investment analysts have total freedom to invest in any assets they believe offer good value, so long as they remain within the range of risk established in advance by our clients.

Each of the five investment strategies Pinnacle offers has a unique risk benchmark, determined by back-testing different unmanaged portfolios since 1972 to establish a base range of volatility. For example, the volatility of our Dynamic Conservative Growth (DCG) strategy is comparable to the volatility of a portfolio with 45% stocks and 55% bonds, even if the DCG's actual ratio between stocks and bonds is entirely different. While our analysts are free to find the best value propositions anywhere in the world, they are *not* free to turn a conservative portfolio into an aggressive portfolio with high amounts of potential volatility.

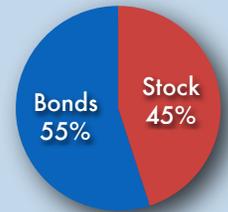
PORTFOLIOS

RISK BENCHMARKS

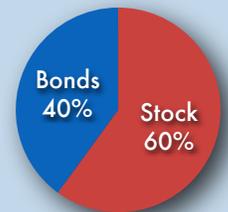
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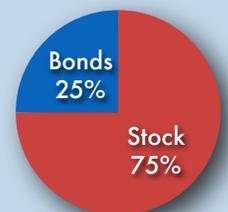
DYNAMIC CONSERVATIVE GROWTH



DYNAMIC MODERATE GROWTH



DYNAMIC APPRECIATION



DYNAMIC ULTRA APPRECIATION



Defending Against Mistakes

We believe the solution to the problems of Buy and Hold investing is active portfolio management. However, active management has its own unique set of concerns. We change our portfolio construction based on our research and analysis of what asset classes offer the best value, but we can never be sure in advance that our view is correct. Unless an analyst really can see the future, the best he or she can do is assign probabilities to future events and then allocate the portfolios based on those probabilities.

Of course, like everyone, we sometimes make forecasting mistakes. That's why we designed our investment process to include a series of safeguards that prevent major errors.

OUR SAFEGUARDS

I

We make investment decisions as a team. Our strategy doesn't depend on a single "superstar manager" who might go on a cold streak and make a series of investment blunders.

II

We use a "weight of the evidence" approach to decision-making that requires a significant majority of factors in reaching investment conclusions. This helps defend against the possibility that dogmatically following any one factor will lead to an incorrect conclusion about the markets.

III

We find investment value using three different methods, which defends against the possibility that any one method might give a false signal.

IV

We make decisions using both quantitative (rules-based mathematical models) and qualitative (judgment, experience and intuition) methods.

V

We typically make only small, incremental changes to portfolio asset allocations, believing that sudden, major shifts put our clients' money at risk.

How We Find Investment Value

At Pinnacle, we change the allocation of our portfolios based on our fundamental belief that asset classes will earn the best returns when we buy them at prices that

represent good values. But what makes an asset a "good value"? We use three difference methods to determine that.

1. Determining the Market Cycle

The economy and financial markets move in a never-ending pattern of economic expansion to economic contraction, and back again. When the economy is expanding, risk assets like stocks, commodities, and real estate tend to earn their best returns. On the other hand, when the economy is contracting, non-risk assets like cash, bonds, and other strategies with low volatility tend to outperform and protect investors from steep declines in portfolio value. The challenge is determining where we are in the cycle at any given time.

Pinnacle analysts look at more than 100 economic indicators each month and pour through stacks of independent investment research to determine if the economic trend is about to shift. In practice, financial markets tend to move in advance of changes in the economy, so the ability to forecast economic adjustments is critical.

2. Technical Analysis

Technical analysts believe that the behavior of investors offers the single best insight into the current state of the markets. Instead of studying fundamental indicators like interest rates, profits, inflation, monetary and fiscal policy, etc., technical analysis examines the movement of security prices.

What is the trend of the market? Are prices either oversold or overbought and likely to revert to the mean? Are there divergences between different sectors of the market? What do investor sentiment surveys tell us about investor attitudes? What does the trading volume tell us about investor enthusiasm? These are the questions addressed by technical analysts.

3. Traditional Valuation

The most famous value investor in the world is Warren Buffett. His investment strategy is to buy a business or franchise when he believes the market has underpriced it. When value investors purchase a stock -- or in our case, an asset class -- at a steep discount to its fair value, they feel they have a built-in margin of safety that protects against market declines. We use many of the tools of traditional valuation analysis in our work, including earning and non-earnings-based ratio analysis, competitive methods of value (like comparing dividend yields to interest rates), and measures of intrinsic value (like Tobin's Q Ratio).

Pinnacle utilizes a proprietary valuation model that constantly evaluates and "scores" a variety of valuation techniques to help us determine if risk markets in general, or a specific asset class, represents a value opportunity.



Earning Excess Returns

Here at Pinnacle, we're always trying to beat our benchmarks and earn excess returns for our clients. Our first strategy for doing so is to change the overall asset allocation of the portfolio with the intention of making significant changes in its volatility. Asset allocation trades would include selling risk assets in favor of less risky asset classes to defend against a bear market. Selling stocks, commodities, or real estate to own bonds or cash are classic changes to asset allocation that have a major impact on portfolio returns. Conversely, buying stocks, commodities, or real estate from cash or bonds in anticipation of a bull market significantly increases our ability to make money during those periods.

Our second strategy for earning excess returns is to utilize "sector rotation" in our portfolio construction. Instead of selling stocks to own bonds, we might sell more volatile sectors of the stock market to own more defensive, less volatile sectors. These trades occur in both the equity and fixed income sectors of the portfolio and are utilized when Pinnacle analysts want to make more subtle changes to the portfolio's risk characteristics.

We're also able to earn excess returns through security selection. Pinnacle analysts first decide what kind of security to invest in -- an exchange traded fund (ETF) or a mutual fund. They must then determine which ETF or mutual fund to buy. The answer often depends on our analysis of a particular manager or market sector.

We typically use ETFs when we feel we have enough research to make good investment decisions using our in-house resources. On the other hand, we use mutual funds when we need to 'hire' a fund manager to invest in a particular market or specific strategy. Security selection can have an important but subtle impact on overall portfolio returns.



A Word About "Market Timing"

In the minds of status quo investors, "market timing" is akin to gambling. They believe that the decision to sell based on the valuation of securities is too risky given the possibility that timers will improperly assess value and sell too early or too late.

We disagree. Active management, by definition, requires an element of market timing. After all, while selling an overvalued security to buy an undervalued security is a risk-reducing strategy, it requires an investor to 'time' the sell and the buy.

The critics are right that taking portfolios to asset allocation extremes is an unnecessary and risk-increasing strategy. That's why we reject the day-trading and short-term swing-trading approaches that advocate keeping 100% of your capital in cash and only deploying it when a trading opportunity presents itself. Taking a portfolio to a 100% cash position means that you are 100% certain of your investment forecast, and no-

one can reasonably claim that. In addition, it would mean abandoning one of our unbreakable investment rules, which is to always own a diversified portfolio. Our investment time horizon is much longer than the one day period of the day-trader. We invest portfolios to outperform over a typical market cycle, which is usually one to five years. While we do analyze short-term market movements when timing our acquisition or sale of specific securities, our fundamental strategy is to take advantage of bull and bear markets over long periods.

When used reasonably and with safeguards in place to prevent major investment errors, market timing is a tool to use in earning excess returns, and not something to be feared or denigrated.



You have dreams...

Goals you want to achieve... places you hope to go... things you want to do... people you yearn to spend time with.

These dreams have motivated you over the years to work hard and to sacrifice, so that one day you would be in the financial position to live the life you've always wanted. But you're not there yet. Achieving your dreams takes more than work and sacrifice... it also takes planning and the knowledge of how to get there.

At Pinnacle Advisory Group, we are experts at helping affluent people like you accomplish their life goals. Whether you want to spend your future retirement...

...traveling the world with your spouse...

...spending more time on hobbies like photography, or wine collecting, or cooking...

...living on a horse ranch in the country or a cabin in the mountains...

...creating a lasting legacy for your children and grandchildren...

...supporting the charities and causes that you hold dear...

Or even if you just want to have the money and guidance right now to do the things that are important to you, we can help.

You see, at Pinnacle, we combine both expert investment management with personalized, unbiased financial planning. We don't think you can separate the two.

After all, what's the point of securing your financial health if you can't do what you want with it? And what's the use of creating a plan to achieve your dreams if you lack the financial means to get you there?

In 1993, our founders started Pinnacle with the goal of creating the perfect financial advisory firm — the kind of place they themselves would feel safe entrusting their own money and future. We think they succeeded. Over the years, Pinnacle has developed a proprietary investment system — the “Pinnacle Investment Method” — along with an independent team that does nothing but analyze the markets and manage our clients' portfolios. At the same time, we have assembled an all-star group of wealth managers who devote all of their attention to individual clients, helping them plan for their future and achieve their life goals.

While large financial advisory companies also have separate investment departments, they lack the personalized attention of a smaller firm. At the same time, small advisories have the personal service, but lack a full-time investment team — advisors are forced to split their attention between serving clients and monitoring the markets.

Here at Pinnacle, we have the best of both worlds. And we'd like to put that to work for you.

If you have a minimum of \$750,000 in investable assets and would like to arrange an introductory meeting with one of our wealth managers, email Brian Saint-Paul at bsaintpaul@pinnacleadvisory.com or phone him at (410) 995-6630.