

# Cornerstone Report

Special Report

November 2nd, 2009

By Jerry E. Tuma, CFP®

## Deflation: An Unfamiliar Foe - Part I



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Over the past few months the stock market has passed markers like lines on a highway, 7000, 8000, 9000 now 10,000. Does anything stand between the market and 14,000 – the old high for stocks? Bigger question: Is the market operating with **true** reality in mind, as it is currently projecting a “V” shaped recovery by 2010 marked by an enormous corporate earnings rebound of at least 20-30%. Or, has the market gotten way ahead of itself – projecting hope and optimism too far into the future?

In reality, it's a little bit of both. Certainly, record money pumping by the Fed combined with a slowed bleed rate for the banking system gives us hope that the worst may be behind us. But reality is that there are far more difficult challenges yet ahead in the economy, between 2010 and 2012. Thus far since March, the market seems to be mostly ignoring future issues. Challenges, what challenges? Don't you know the worst case scenario is behind us?

Well maybe - perhaps the worst case is behind us but I wouldn't be too sure. Reality is, **many** more challenges will face us in 2010, 2011 and 2012, as we will document in this **Special Report**. Far too many economic chickens have yet to come home to roost. Our job is to look for the eggs, as in where are the opportunities? Where exactly are the challenges coming from and how can we take advantage of them? Let's deal with both the challenges and opportunities, but let's start by looking at the positives.

### **POSITIVE FACTORS:**

**Stocks on the March** - - The first and most obvious factor favoring a positive economic outcome is the performance of stocks. Thus far stocks have seen an enormous rebound from their lows – recovering almost half of their losses. While you have to give the market the benefit of the doubt to some extent, history is replete with examples where stocks seemingly forecast miracles, only to later succumb to the forces of gravity.

The subject matter of this *Special Report* is **deflation**, Ben Bernanke's worst nightmare and current enemy. Deflation truly is an unfamiliar foe. Most of us have lived our entire lives with rising prices; thus it is almost as if we think that's the way God created the world. But it's not. Deflation, where asset prices *fall* as the banking system and debt structures contract, has occurred many times in past history and two times over the last century, most notably during the 1930's Great Depression and the late 1990's to the

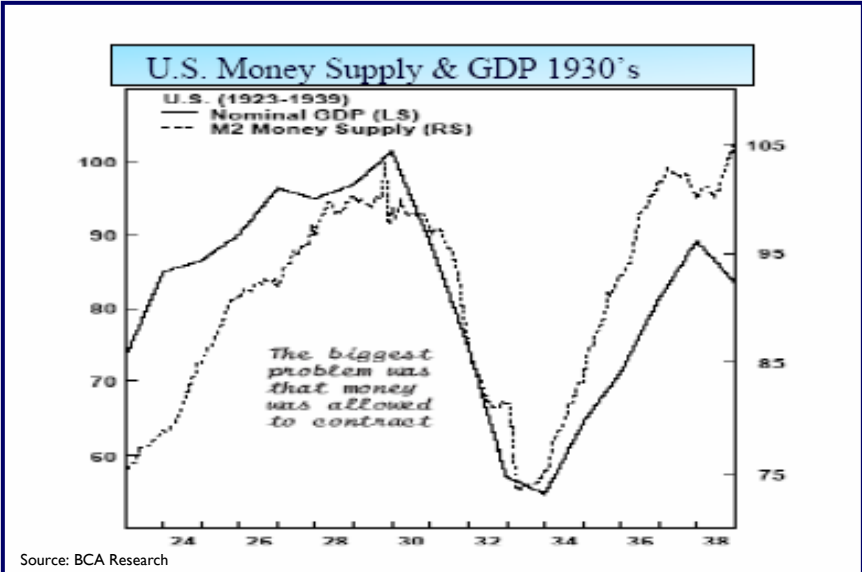
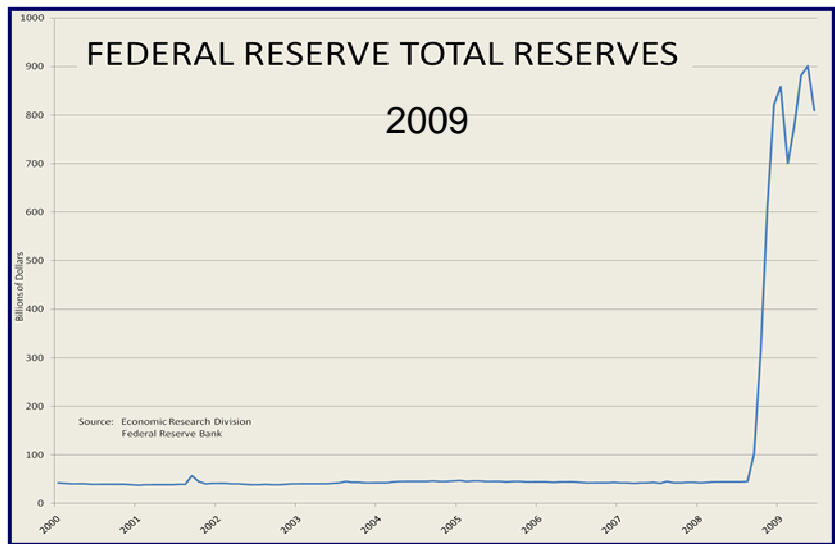
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present in Japan. Historically, deflations occur on the heels of massive credit, real estate and/or stock market bubbles, and the one we've just seen was definitely the largest in history.

While I'm not stating that we'll necessarily have the same outcome as either of these two previous cases, they do provide us with precedents to study. Stocks, while historically good at forecasting an economic rebound, are not infallible. The first bounce of the Great 1930's Bear recovered a larger part of its loss than we've seen so far this year. Japan had no less than four, count them four bounces of over 50% between 1989 and the present, yet today still languishes some 70% below its all time high. So, on the one hand, I don't want to completely discount the market's rebound, I also view it with a degree of skepticism until we see other signs that we're truly out of the woods.

**Roll the Printing Presses** - - Determined to avoid the mistakes of his 1930's predecessors, Bernanke and company have way outdone the work of any other Fed President. In fact, I'd say they've probably printed more money over the last year than almost ALL previous Fed Presidents **combined!**

Without history as our guide it's easy to get lost. Sometimes we still get lost, even **with** history to guide us. So, before you see the next chart, realize that normal money supply expansion by the Fed averages between 3-6% per year. Historically, a 3% expansion rate risks the economy stalling into recession, 6% expansion risks inflation.



**Money Supply and GDP**

Note: Fed Reserves have more than doubled this year. Contrast this with the 1930's when both the money supply and Gross Domestic Product fell by one-third.

In this chart you can see the latest Fed stats showing an increase of ***over 100% this year!*** This is truly unprecedented. What this means is that the Fed has decided to pull out all the stops to avoid a 1930's style repeat, printing over \$1 trillion in the process. While there are still no guarantees, at least we know that the same mistakes of 1930 and 1931 are not likely to be repeated.

In 1929, once the market began to crash, banks were allowed to continue falling. At the time the idea was that it was good to cleanse the excesses from the system – sort of a financial version of survival of the fittest, but things got out of hand. Almost one-third of all banks crashed in the 1929 – 1933 period, resulting in panic, hysteria and severe contraction of the money supply (about a one-third contraction). As the banks failed it forced more asset sales, pushing asset prices lower and lower, until finally someone stopped the madness. Franklin Roosevelt created the FDIC insurance system, which halted the bank panics and the systemic hemorrhaging. By that time real estate had fallen sharply and stocks had fallen almost 90%.

There's an old saying that history never repeats itself exactly, but it often rhymes. Thus far we have actually seen much more severe asset deflation in terms of housing and stocks than first occurred in 1930 (the beginning of the 1930's deflationary period) but we have also seen great differences given the reaction of the Fed. Some are making the case that the crisis is over.

Yet, you have to respect history, and the history of massive debt and asset bubbles is not encouraging. For now at least, the Fed appears to have slowed the hemorrhaging. What remains to be seen is what will happen as the next round of economic challenges begin, which could start anytime but likely no later than late 2010.

In sum, we see two major positives to the current economic equation, the behavior of stock prices and the Fed flushing the economy with unheard of amounts of liquidity. Anything less by the Fed and "Armageddon" type economic fears would likely have become reality. They still could become reality later, but at least for now the Fed has bought some time.

## **NOW THE CHALLENGES:**

**Rocky Residential Real Estate Part II** - - Housing prices have not bottomed. How do we know? Simple supply and demand. For a market to bottom, prices must reach what in economics we call "equilibrium" – supply and demand being roughly in balance. The last few months we've seen a minor up-tick in home prices nationwide, resulting in the bulls declaring that real estate has bottomed. But has it really?

Given the fact that housing prices have seen a slight up-tick, let's assume for the moment that supply and demand, (at least temporarily) has balanced out. That means that enough bargain hunters have come into the housing market and purchased enough homes to soak up the current available inventory of homes for sale, as equilibrium is reached. (For now we'll ignore the fact that ***seasonally*** housing prices virtually always firm between April and August during the peak buying season.)

But, assuming that we have reached equilibrium - - current supply/demand are in balance (which I do not believe is true, but assume that it has for the sake of illustration) what about future supply? In other words, if we know that an enormous amount of *future* supply is coming into the housing market, if for example an enormous influx of foreclosed homes were to hit the housing market, that almost certainly would push prices lower again – greatly exceeding current buying demand. Such is about to be the case.

**Shadow Inventory Lurks Ahead** - - *Amherst Securities* recently published a study estimating the number of houses currently somewhere in the foreclosure pipeline. In other words, these are houses not yet being counted as available inventory, but which must be purchased or absorbed into the system within the next 12–18 months, as they will soon be dumped on to the market via the foreclosure process. According to their estimates, based upon data taken from the Mortgage Bankers Association, an additional **7 million homes** are currently somewhere in the process of foreclosure, but have not yet shown up in the statistics.

This study was based upon the current number of homeowners that are at least thirty days late (30, 60, 90+ and so on) on their mortgages, multiplied by the respective “cure rate” or percentage that ultimately are likely to default and be foreclosed upon for each category. Currently almost 13% of all mortgages are delinquent. After adjusting for the cure rate for each respective category, it is estimated over 90% of those loans will ultimately default. With 55 million mortgages currently outstanding – this projects to almost 7 million defaults hitting the housing market within the next two years. I don’t know about you, but my best guess is that 7 million more foreclosed homes will certainly exceed current demand, thus pushing residential real estate lower yet again, with all the attendant implications to the banking system.

To make matters worse, an enormous number of Alt A and Option ARM mortgages are beginning to default and will either reset to higher interest rates or higher payments (due to gimmicky interest only mortgages converting to conventional mortgages) between now and 2011 when the residential housing storm could finally be over. Worse yet, most of these problem loans exist in the hardest hit “bubble” states of California, Florida, Nevada and Arizona.

### A Primer on Option ARM’s

1. An option ARM is an adjustable-rate mortgage typically made to a prime borrower.
2. Banks typically relied on the appraised value of the home and the borrower’s high FICO score, so 83 percent of the option ARM’s written in 2004-2007 were low or no document loans (“liar loans”). As you can see from the enclosed chart, Option ARM defaults are skyrocketing, now up to a 30% default rate nationwide. Alt A’s are approaching a 20% default rate. Default rates on the mortgages have NOT been factored into either bank losses or home inventory statistics due to the long period it takes from the time when a homeowner stops paying the mortgage until actual foreclosure takes place.

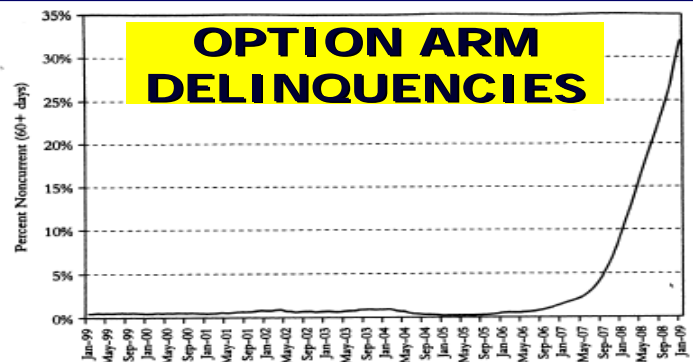


Figure 4.19 Option ARM Mortgage Delinquency Rate  
SOURCE: Amherst Securities, LoanPerformance, T2 Partners estimates.

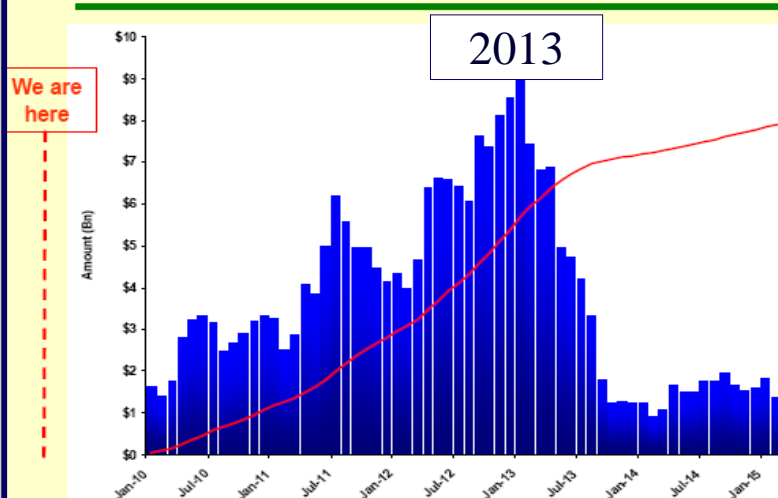
3. Each month the borrower can choose to pay: 1-the fully amortizing interest and principal; 2-full interest; 3-an ultra low teaser interest-only rate (typically 2-3 percent), in which case the unpaid interest is added to the balance of the mortgage (meaning it is negatively amortizing). Approximately 80 percent of option ARM's are negatively amortizing. Lenders, however, booked earnings as if the borrowers were making full-interest payments.

4. A typical option ARM is a 30- or 40-year mortgage that resets (*recasts*) after 5 years when it becomes fully amortized. If an option ARM negatively amortized to 110-125 percent of the original balance (depending on the terms of the loan), this triggers a reset, even if 5 years have not elapsed.

5. Upon reset, the average monthly payment jumps 63 percent from \$1,672 to \$2,725 (\$32,700 annually). (Source: Excerpt from Jerry's new book, ***From Boom to Bust and Beyond***.)

**A Primer on Alt A's** - - Alt A's are euphemistically know as "liars loans" because no income or asset verification was required prior to taking out the mortgage. Thus it is suspected that enormous numbers of these loans were "fudged" creating a likely ticking time bomb due to go off when the mortgages "reset". (Most again were in California, Nevada, Arizona and Florida.)

#### But a Wave of Alt-A Resets Is Ahead of Us



Both Option ARM's and Alt A's are on almost exactly the same path for foreclosure as sub primes, the difference being WHEN they were issued.

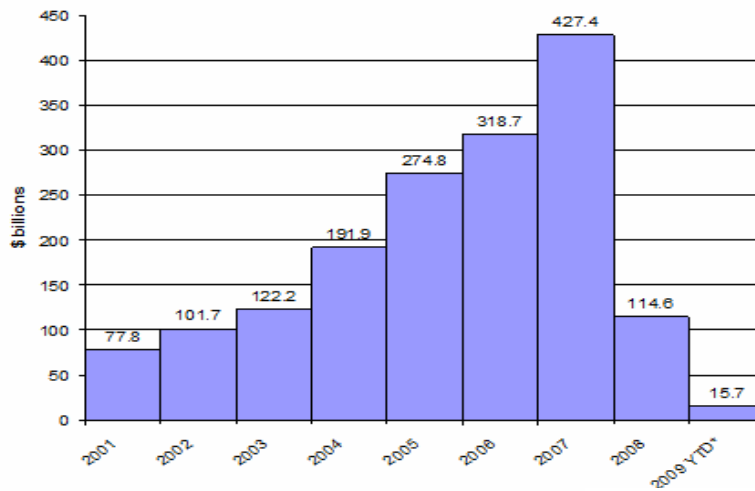
Sub primes hit the system earlier because they came earlier in the cycle, earlier in the 2000's decade. Alt A's and Option ARM's were issued later on, subsequently will default later on, but ultimately could have **twice** the impact due to their size.

There were **\$2.5 trillion** Alt A mortgages issued, when added to option ARM's the total **more than doubles the amount of sub-primes**. Currently 20% of Alt A's nationally are in default and climbing. This will be a veritable train wreck before it's over.

In short, I see little or no let up for housing prices nationwide for at least two more years. No matter how much money Bernanke prints, he can't overcome the burst housing bubble. Eventually things will bottom out, but not without more pain.

Verifying this, Fiserv (which has been very accurate in their house price estimates to date) released a study October 20<sup>th</sup> and is projecting another 11% housing drop - - next year. Foreclosures recently hit their worst three month stretch of all time as 937,840 homes were foreclosed between July and September (www.cnnmoney.com 10-15-09). More housing problems are definitely headed our way. (Incidentally Fiserv projects Dallas housing to **rise** by 1/10<sup>th</sup> of

### Sales of Large Commercial Properties

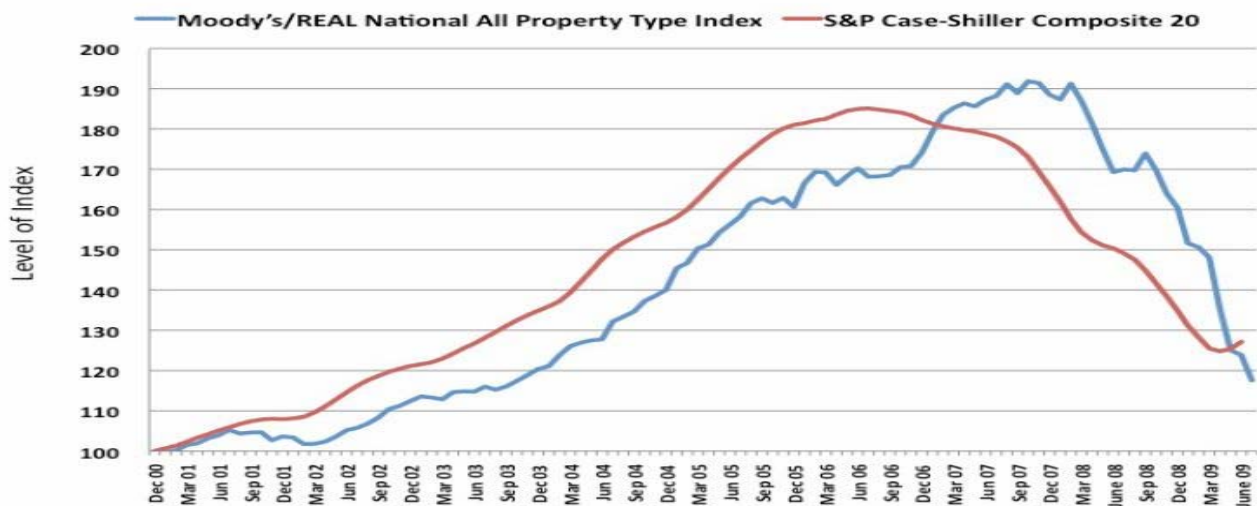


Source: Real Capital Analytics.  
 Limited to properties \$5 million or greater.  
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1% in 2010. Not all real estate is created equal. Look at [www.cnnmoney.com](http://www.cnnmoney.com) and search for the article, “Homes: About to Get Much Cheaper”, dated October 20<sup>th</sup>, 2009 and use the state/city pull down menu to view local real estate forecasts.)

**Commercial Real Estate Problems, Dead Ahead** - - In addition to residential housing, which continue to have problems in the most volatile states (i.e. California and Florida), commercial properties now face a similar situation. This chart shows that over a trillion dollars of commercial

### Real Estate Prices: Commercial vs. Residential



[blogs.reuters.com/rolfe-winkler](http://blogs.reuters.com/rolfe-winkler)

Sources: Moodys/REAL Commercial Property Price Index, S&P/Case-Shiller Home Price Index

real estate was purchased at or near the top of the market between 2005 and 2007. Most of these properties financed with 5 year **interest only** loans. This means that the 2005 properties come due for refinancing in 2010, the 2006 properties in 2011, etc.

The chart above shows just how bad commercial property values have plunged, **amazingly** exceeding the decline in residential properties nationwide. Again, these are mostly interest only loans that have to be refinanced when they come due. But how do you refinance a property that has fallen 40% in value, when in most cases you *owe* more than the property is now worth?

In addition, most commercial real estate is financed by commercial banks, not government sponsored entities like FNMA or Freddie Mac, so the banking system faces further trauma. Commercial real estate is an enormous crisis that is just beginning to unwind.

**Hobbled Banking System** - - In the next table from Institutional Risk Analytics, you see their current analysis of the banking system *prior* to 2010 – 2012 commercial and residential real estate problems hitting the fan.

This shows that while only 8% of the banks in the country were rated “F” in 2006, they now have 28% of the banks rate an “F” today, representing over 2256 banks.

While the obvious good news is that there are still over 5000 banks with an “A” or “A+” rating, almost one-third of the nation’s banks appear to be in distress, reflecting all of the lunacy with residential and commercial lending, leverage, etc., *before* we see the next round of foreclosure problems.

So tell me, just exactly how do we get a 20-30% corporate earnings bounce next year (an enormous recovery) with almost 30% of our banks in distress and facing even more pressure over the next two to three years?

**Overextended Consumer** - - A recent American Express poll of over 2,000 respondents asked what they would do if they found \$500. “The answers were like a pitcher of ice water in the face of retailers,” says the L.A. Times. A list of possible spending choices including splurging at a restaurant, going on a shopping spree and taking a trip. But a mere 10 percent marked one of those items. Most went down the list and checked off paying regular bills, reducing credit card debt or simply saving the money.

Consumers are exhibiting a level of discipline that seemed to shock American Express. But as creditors invariably do and as a *deflationary* trend grabs hold, American Express “has reinforced the reduced-spending trend by issuing fewer cards and slashing credit lines to lower their own risks.” (Source: Elliott Wave Forecast 9/25/09.)

**Negative Feedback Loop** - - Reduced demand is reducing demand, as consumers spending cutback and credit cutbacks soften business, which causes further unemployment, which

#### IRA Bank Stress Index Distributions (FDIC Insured Banks)

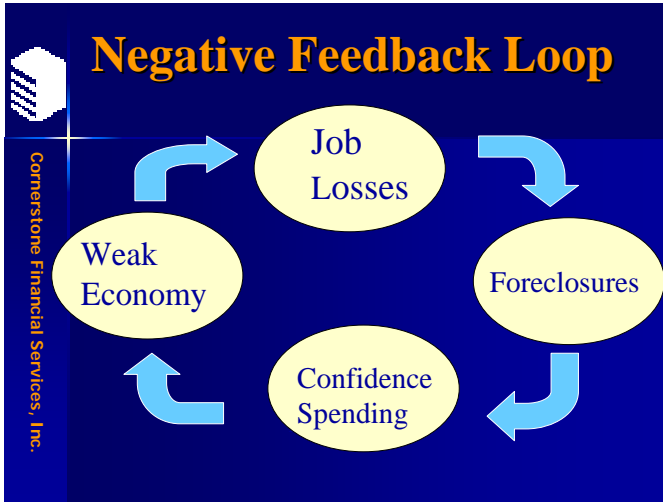
Period	A+	A	F	%F
2009-06	3518	1449	2256	28%
2006-12	6370	134	697	8%

Source: FDIC/Institutional Risk Analytics (IRA) Bank Monitor

“U.S. and many global consumers gorged themselves On the Big Macs of all varieties; burgers to be sure, but also McHouses, McHummers, and McFlatscreens, All financed with excessive amounts of McCredit created under the mistaken assumption that the assets prices securitizing them could never go down. What a colossal McStake that turned out to be.”

- **Bill Gross**

(CEO of PIMCO – World’s largest fixed income manager.)



softens business yet again.

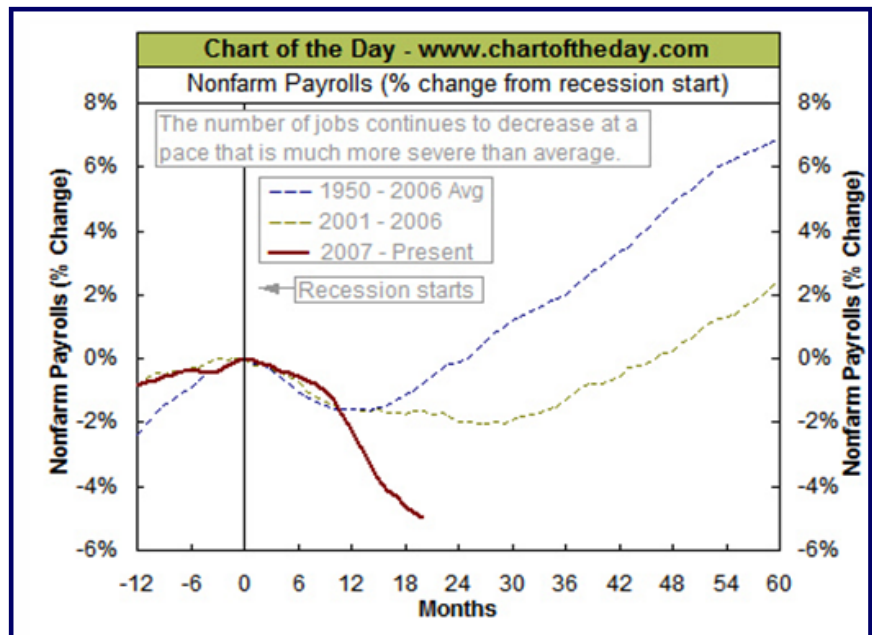
We are at present stuck in a deflationary environment where weaker consumer spending produces weaker demand for products and services, which in turn leads to fewer sales, thus resulting in more layoffs. The cycle continues, it intensifies.

While the unemployment rate has hit 9.8%, the *underemployment* rate, which includes the officially unemployed, plus those whose benefits have expired, those who have given up looking for a job, and those who are involuntarily working

part time, has risen to 17%. Thus 26 million Americans are unemployed or underemployed. This means almost one out of five Americans is facing serious employment issues; on top of that almost everybody knows someone facing employment issues.

The robust levels of consumer spending necessary to produce a vigorous recovery are nowhere in sight. Note the alarming drop in employment in the above chart, showing this recession vs. previous recessions back to 1950.

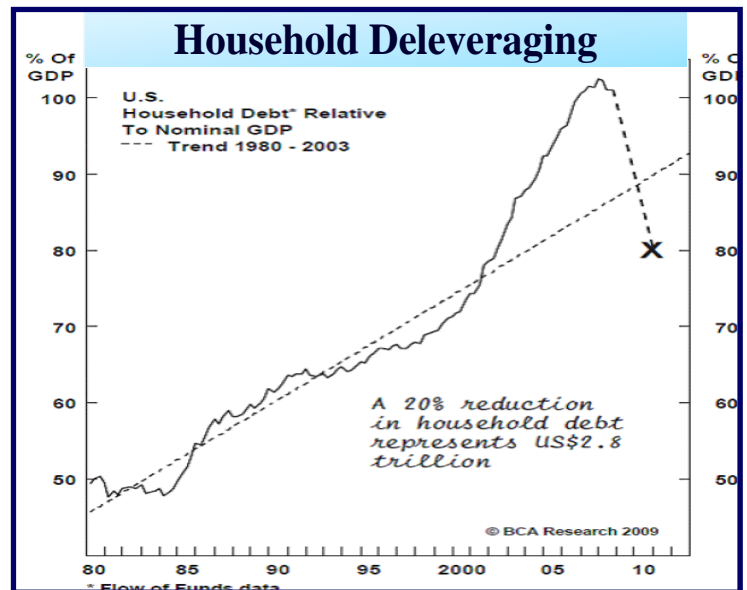
Regarding U.S. Baby Boomer spending, the dominant consumer group in the world, demographer Rodney Johnson had this to say; "On a more basic level, what exactly are the Boomers going to buy? A man or woman in their 50s already has the "big ticket" items like appliances and home electronics. They probably even have a high-end cappuccino machine they bought circa 1998 (and never use). The closet is like already full of expensive work clothes they don't intend to wear much longer. They probably already own a great grill that sits on a beautiful deck, neither of which gets used much.



Sure, they probably eat in nicer restaurants and they probably enjoy traveling. But when it comes to the big-ticket items that drive the economy, they are pretty much done. With retirement only 10 or 15 years away, that money is better saved." (Source: HS Dent Forecast 10/1/09.)

Indeed, over the last decade consumers nationwide engaged in a veritable feeding frenzy of spending and debt. The next chart indicated just how “bubbly” consumer debt became, moving way past the baseline of normal spending growth.

Inevitably, the bigger the boom, the bigger the bust. Just as the spending/debt boom was enormous – the bust will be as well. (Note: Historically major overshoots like the credit bubble seen below do NOT stop at the trendline, they normally overshoot on the way down due to emotions and crashing liquidity before returning to normal.)



Now consumers are not only deleveraging (paying off debts and saving money) for the first time in decades, but it's almost as if we're establishing a new social norm. Frugality has become a virtue. Gone forever (at least our lifetime) are the wild spending days of the late 1990's and early 2000's. A recent poll of mothers (who account for 80% of a typical families spending) show that they have permanently changed the way they spend and will never revert to previous spending habits in their lifetimes!

Not only are we seeing social transformation to a more financially conservative way of life (in terms of consumption and debt), but now most of the 76 million Boomers are well beyond their peak spending years, with a lot less in their retirement accounts than they'd anticipated.

People naturally tend to become more conservative as they age anyway, both in terms of spending, debt and investing. Now that the largest consumer group in world history has moved into their more conservative years another spending boom is virtually impossible, a fact ignored by most politicians, the media and traditional economists. “The age of thrift is here,” declared Steve Reinemund, chairman of PepsiCo.

### Conclusion:

As much as the politicians, authorities and the media want to proclaim the crisis over, reality is that it is FAR from over. A “V” shaped recovery requires two things:

- #1 **A Healthy Consumer who is Willing to Spend** - - During “normal” recoveries pent up demand for housing and cars typically lead us out of the box, as consumers who have put off purchases due to job loss fears and/or uncertainty jump back on the spending bandwagon. But in the late 2000's consumers went on a wild spending spree, grossly overextending themselves on spending of every sort, and in many cases using their now depleted home equities as a veritable ATM machine, withdrawing home equity spend on new cars, exotic vacations, expensive consumer items and upgrades. Consumers went on a wild spending bender, now they have an enormous hangover and just don't feel like partying again.

The unemployment situation remains the worst since the 1930's in terms of duration (how long people have been unemployed). The average duration for unemployment is 26 weeks with the proportion of unemployed out of a job for more than 26 weeks at the highest level since the 1930's. Job uncertainty will continue to cast a shadow over the economy for the foreseeable future.

Cash for clunkers merely stimulated short term sales by borrowing sales from the future. The consumer is in no way, shape or form about to go on another binge and spend BIG TIME right now, not enough to produce a strong "V" shaped recovery.

**#2. Healthy Banking System** - - Our system is fueled by consumer spending (over 70% of GDP) and credit. We're a debt based, consumer driven economy. With almost a third of the banking system in jeopardy currently, *before* the next round of problems, banks will not be making aggressive loans or even pursue "normal" lending practices for several years. They continue to pull in their horns. One bank president I know recently said, "We're just trying to keep from stepping on any land mines right now." Most bankers are scared to death of the current environment and healthy lending is required to refuel our economy.

The 3rd quarter GDP bounce of +3.5% appears to be mostly a combination of cash for clunkers and home sales based upon the first time home buyer tax credit. What happens when artificial government stimulus ends, as it inevitably must?

End user demand for most products and services has not picked up appreciably. The rest of the economy "grew" at an annual rate of 1.5%, better than plunging but hardly a party and dangerously close to stalling out again. Ultimately, any economic rebound is built upon top line revenue growth (increased sales) not cost cutting and restocking inventories which is what most corporations have been doing.

As we said in the July issue of our Special Report, ". . . none of this signals that the recession is over. Since WWII 8 of the last 11 recessions have experienced at least one positive quarter of GDP growth. One quarter or so of positive growth in this cycle would not surprise us. Yet as best we can tell there are many more problems dead ahead, as the bursting of the mega credit/housing bubble comes home to roost".

So to say it's all over, in my opinion is the height of folly. No one can predict exactly how the next two years will play out, but one thing we know for sure, we are facing challenges of epic proportions in terms of the burst bubble. As real estate assets continue to deflate in bubble areas of the country.

Despite all the Fed's money printing, it does not fuel economic growth when the money gets parked in the banking system. Banks are reluctant to lend, consumers reluctant to spend. No "V" shaped recovery here.

So my current concern is that the market has bounced back largely upon hope and optimism, with little reality to back it up. I truly believe that the 'emperor has no clothes'. I see no "V" shaped recovery now or anytime soon, and unfortunately stocks are priced for a best case recovery scenario.

Corporate insiders don't seem to buy into the party line either, as the latest buy/sell ratio for corporate insiders (CEO's, directors and corporate officers) is running 30-1 on the sell side. In other words corporate insiders, who should have a better feel for the business outlook and prospects for their own company, are fleeing their own companies' stock like rats from a sinking ship.

Insiders are neither perfect on their track records nor their timing, but normally are pretty good at assessing their companies' value. Overall, they've got a very good track record at knowing when to begin accumulating shares of their company, when the stock price appears cheap and prospects are bright. They are normally selling en masse when they think their companies stock is either overpriced or prospects look bad. Current insider selling en masse is not a good sign.

The biggest asset bubble in world history has just popped and has not finished deflating. Furthermore, this not only involves the largest consumer group in world history (U.S. Boomers dominate the U.S. economy and the U.S. economy dominates the world) but also enormous asset bubbles in Europe as well (the emerging world's economies have fared better respectively). This bubble, which took 25 years to build up, is not likely to completely deflate in one year. While it will likely take a decade or longer to completely unwind, I believe the bulk of the asset bubble likely finishes deflating by 2011 or 2012. **Real** recovery requires more unwinding of the debt and spending excesses, and simply more time.

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