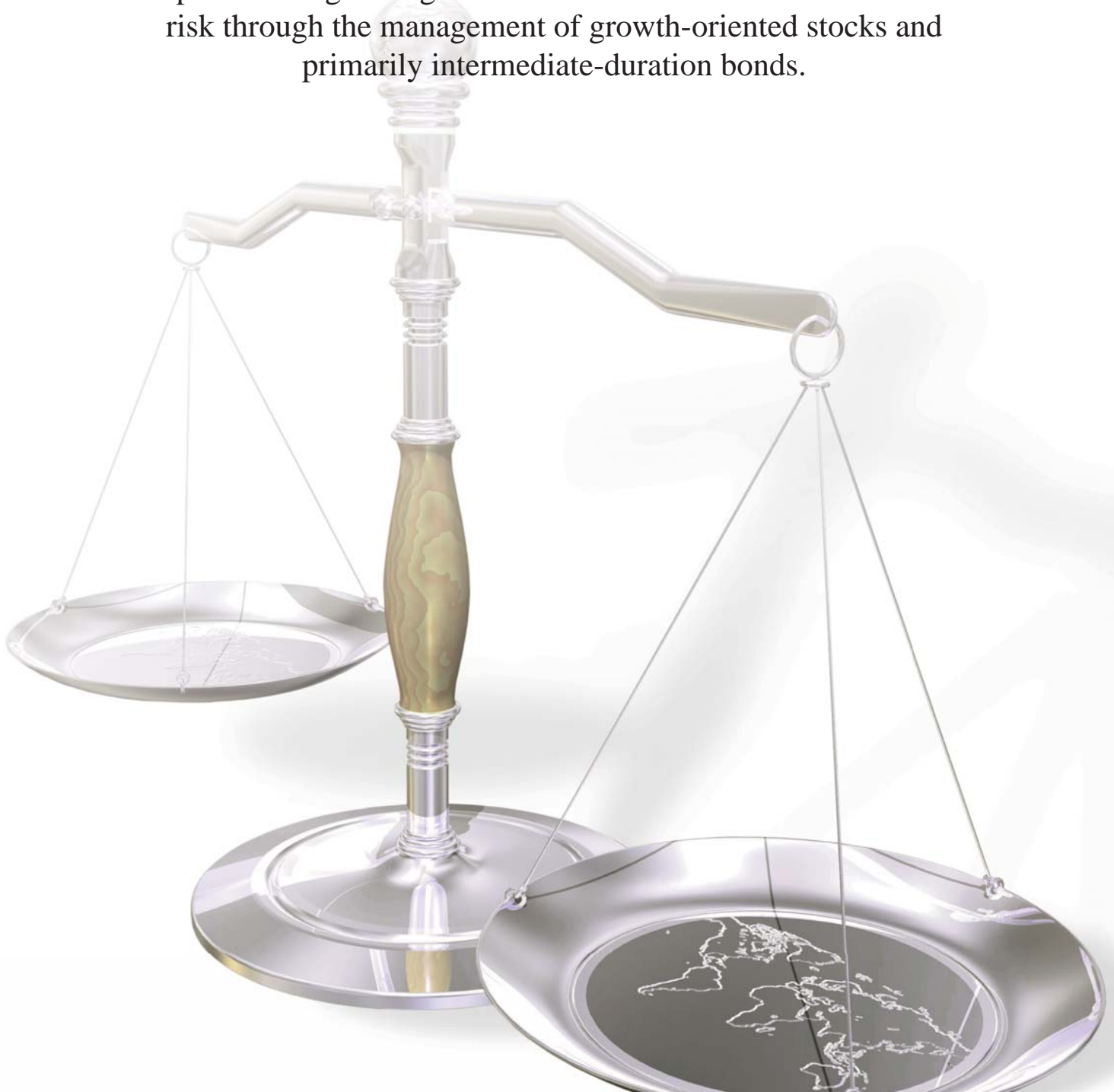


## BALANCED CORE PORTFOLIO

### Portfolio Objective:

To provide long-term growth and current income with controlled risk through the management of growth-oriented stocks and primarily intermediate-duration bonds.



# BALANCED CORE INVESTMENT PROCESS

## EQUITY STRATEGY

Capstone's Core Equity Large Cap Growth strategy invests primarily in high quality, large capitalization growth stocks. We believe that our disciplined, bottom-up approach which combines objective quantitative work with subjective stock evaluation, will provide above average long-term growth in our clients' portfolios, while at the same time explicitly controlling for portfolio risk.

### Step One: Quantitative Analysis

Equity portfolio management is a winnowing process of reducing a large universe of stocks to the 35 to 45 names that are used in clients' portfolios.

Beginning with a database of large capitalization stocks (generally with a market capitalization no smaller than \$5 billion), this universe is screened against four basic criteria as follows: historical growth, expected growth, valuation, and relative price performance/momentum. Each of these four criteria contains sub-measures which are indicative of favorable or unfavorable performance.

For example, some of the measures used for historical growth include improved earnings per share over the previous year and improved return on equity. Expected growth criteria include the trend in earnings estimates and earnings surprise. Valuation is measured by the stocks price-to-earnings ratio in relation to the market and the company's own growth rate. Momentum measures include relative stock performance over the past year as well as the relative performance of the industry in which the company participates.

The end result of this quantitative step is a smaller universe which includes only those stocks representing characteristics associated with outperforming the market. It is this group on which we conduct fundamental analysis.

### Step Two: Fundamental Analysis

The heart of Capstone's fundamental equity analysis focuses on the competitive position of the company within its industry. Extraordinary returns do not arise from ordinary companies. We search for companies which have a demonstrated franchise

value. This might arise from a technological edge relative to competitors, better management, or brand recognition. In addition, we seek out companies for whom the threat of new competition or product substitutes is relatively low. Companies that can, to the greatest extent, control product pricing and production costs are most desirable. We have found that industry leaders tend to remain in that position for extended periods of time and pay handsome rewards to patient investors.

Unlike years past when obtaining general company-related information was the difficult part of fundamental research, one of the more difficult fundamental tasks today is the ability to distinguish the useful information from the flood of all the other data which is now so easily obtainable.

### Step Three: Portfolio Formation

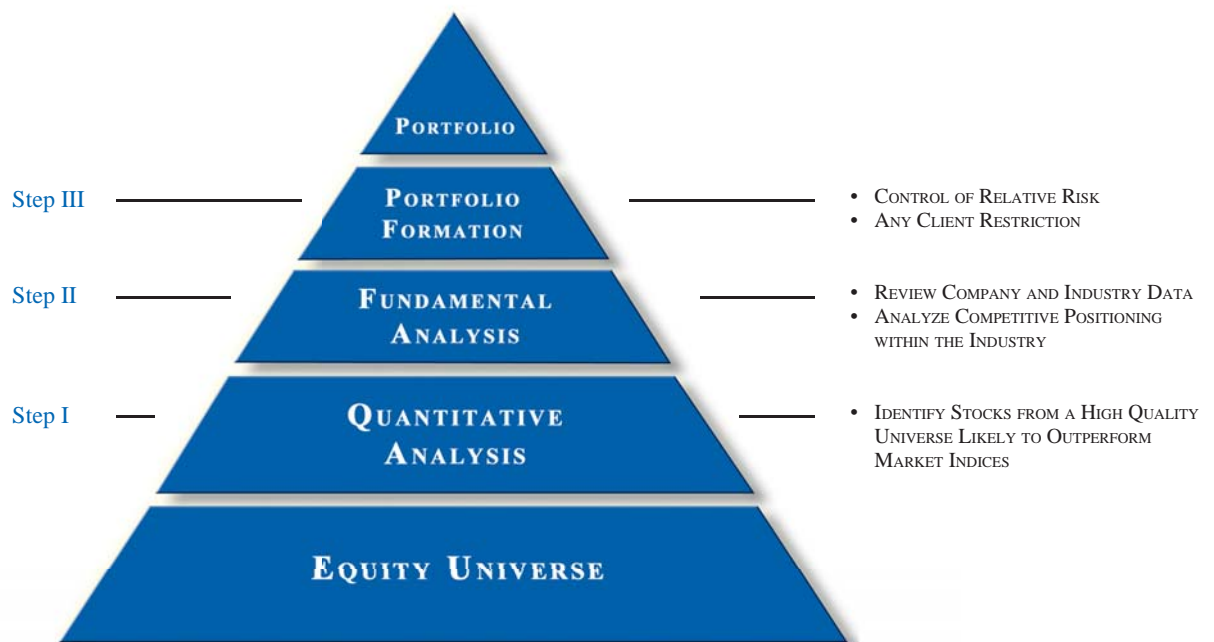
After completion of the quantitative and fundamental work lies portfolio formation. At this stage in the process, we generally have more candidates for purchase than places available in the portfolio. Quantitative risk analysis is used to help select the best stocks and the best

weighting of each stock. This is done in order to construct a portfolio the relative risk of which is precisely measured and which is within acceptable risk tolerances. By selecting the best candidates through our quantitative and fundamental steps, we can build portfolios which are superior to the market because they offer more return than the market for every unit of risk taken. Moreover, because our process generates multiple candidates for entry into the portfolio, an ongoing competition exists between companies which are held in the portfolio and those which are candidates for entry. This assures that the clients' account is always assessed not only by the measure of what is owned, but also by what is not owned. In addition, alternate ideas are always available.

### Sell Discipline:

Capstone's sell discipline is the opposite of its buy discipline. If stock held in the portfolio is not one which our buy discipline would lead us to own today, it is sold. We have no "hold" category.

In addition, if a stock is down 30% relative to the market and fails our quantitative tests, it is sold.



# BALANCED CORE INVESTMENT PROCESS

## FIXED INCOME STRATEGY

Capstone's Fixed Income strategy invests in primarily intermediate-maturity, government and corporate bonds. Our fixed-income approach is based on the belief that superior long-term returns can be achieved with less-than-market risk by focusing on high quality securities, and by adding value through active duration management and the selective rotation of market sectors and the securities within those sectors. For investors who require a relatively low risk/high quality portfolio to meet short-term objectives, we adapt our fixed-income process. Investments under this discipline are matched to the client's cash flow and liquidity needs by reducing duration/maturity characteristics and enhancing current yields.

### Step One: Maturity Selection

The process begins with an analysis of the domestic and international economies, the political environment and the current state of the credit market. Based on the analysis of these variables, an interest rate outlook for the next six months is established. Maturity is then

determined which is designed to maximize return and minimize risk.

For investors who have shorter-term horizons and require the highest degree of principal safety, customized portfolios are constructed to match asset cash flows to expected liabilities.

### Step Two: Yield Curve Selection

Once an average maturity target for the portfolio is established, a decision needs to be made as to the allocation of assets along the yield curve which will achieve the targeted average maturity. Discussions and analysis answer questions such as 1) should the portfolio invest primarily in the targeted maturity range (bullet strategy) 2) should the portfolio invest somewhat equally along the yield curve (modified ladder strategy) or 3) should the portfolio overweight in short-term and long-term securities (barbell strategy)? These decisions are based on the current and projected shape of the yield curve in an attempt to identify the optimal mix of maturities that would provide a high level of income adjusted for risk.

### Step Three: Sector Selection

Market sectors are now compared to determine which sectors offer the most current value. The primary sectors utilized include: U.S. Treasuries, U.S. Agencies, industrials, finance, banks, utilities, telephones and mortgage-backed securities. Some portfolios may be restricted to particular maturity guidelines, sector constraints or quality limitations to name a few customizations available.

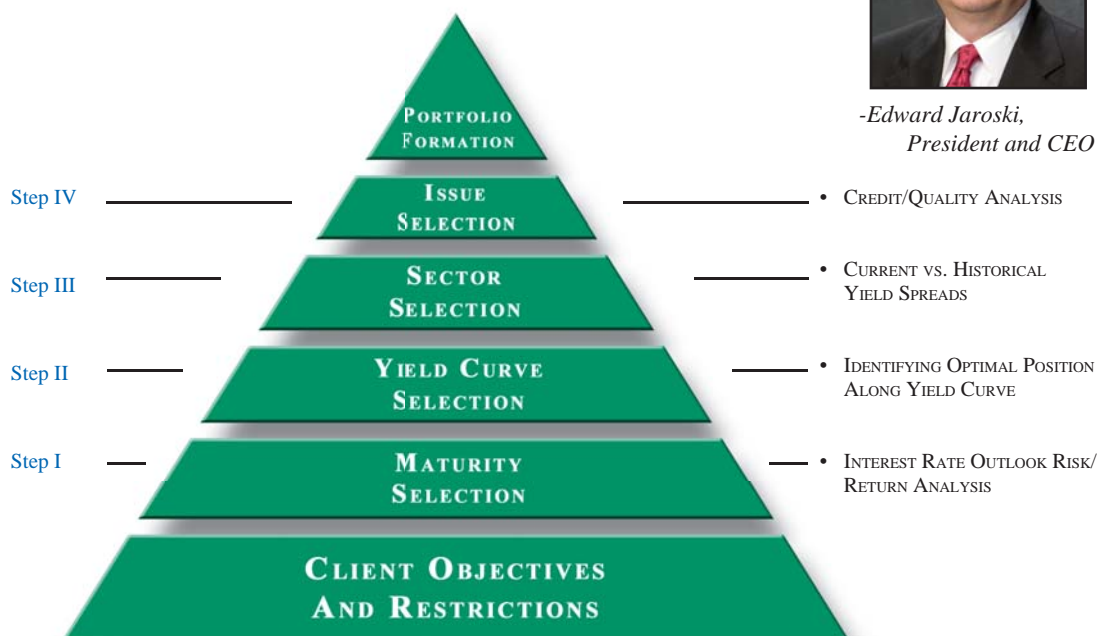
### Step Four: Issue Selection

The final step is selecting the most attractive issues within the most attractive sectors. Each issue undergoes a thorough quality analysis before it is added to the portfolio. All securities are rated investment grade at the time of purchase, with an average portfolio rating of "AA". Once issue selection is complete, overall portfolio characteristics are monitored for compliance with client objectives and restrictions.

*"Capstone's Balanced Core Portfolio combines Large Capitalization Core Growth with Fixed Income. This strategy seeks to provide a balance of growth and income. The allocation ranges between 40% and 60% stocks and bonds. We can customize the allocation to fit individual needs."*



-Edward Jaroski,  
President and CEO



Capstone Asset Management Company  
3700 West Sam Houston Parkway South #250  
Houston, Texas 77042  
Phone: 713.260.9000  
Toll Free: 800.262.6631  
Fax: 713.260.9050  
E-mail: [info@capstonefinancial.com](mailto:info@capstonefinancial.com)  
[www.capstonefinancial.com](http://www.capstonefinancial.com)