Cornerstone Financial Management LLC
Economic and Financial Markets Review
2011 Third Quarter

Highlights

- Revised economic data showed that the U.S. economy experienced real GDP growth of only about 1% during the first half of 2011, leading to concerns of a "double dip" or a new recession. The residential housing market remains a major drag on the U.S. economy.
- Inflation during the trailing 12 months reached 3.8% due largely to commodity price increases for food and petroleum. Coupled with a lack of significant job growth, high unemployment, and little increases in wages, most consumers are finding their real incomes are declining.
- Persistent headlines concerning the European sovereign debt crisis and the U.S. debt ceiling negotiations rattled investors.
- Stocks around the globe suffered double digit losses in the third quarter as a result of recession fears in the developed economies of Europe and North America, coupled with sovereign debt woes in the peripheral European countries.
- A flight to the perceived safety of U.S. Treasury bonds pushed investment grade bonds prices higher and yields lower. The yield on the benchmark 10-Year Treasury bond set a post-World War II low of 1.72% in late September.

Investment Recap

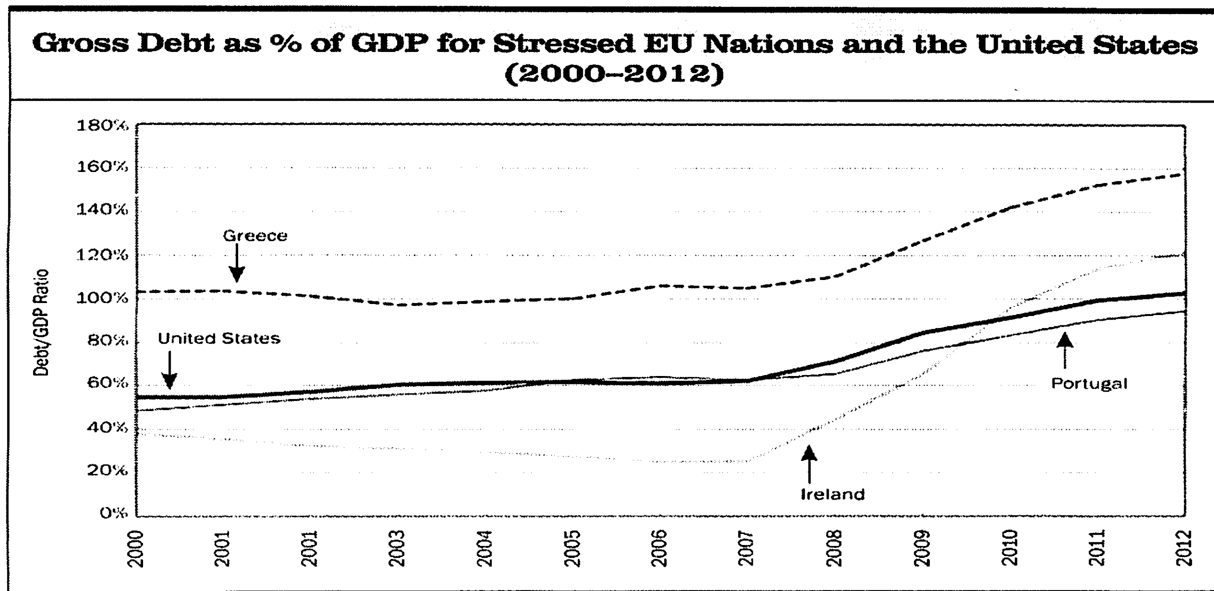
Concerns about Europe's sovereign debt woes and negative global economic news ignited recession fears and drove stock prices around the world down sharply in the third quarter. U.S. large cap stocks fell roughly 14-15% during the third quarter and have lost approximately 9% year to date. U.S. mid cap and small cap stocks suffered larger quarterly losses, down 19-22%, and are off 12-18% for the year through September. Growth style investments outperformed value style investments uniformly across all market cap sizes in the U.S. Foreign stocks also suffered double-digit declines, losing approximately 19% for the quarter and 15% for the first nine months of the year. Foreign emerging market stocks suffered the largest losses of all equity categories for both the quarter (-23%) and year to date periods (-22%).

Investors sought shelter in U.S. high quality bonds, which generated positive returns in the 3-5% range during the third quarter. Through the first nine months of the year, high quality intermediate-term bonds have generated positive returns in the 5-10% range, driven primarily by a flight to the relative safety of U.S. Treasuries. As expected, low quality high yield bonds had negative returns for the quarter and have posted small single digit losses for the year-to-date period. Please refer to the table of index returns at the end of this review for further details.

Politics and Economic Policy

Since 2008, we have been in a period where forces such as the debt crisis in the developed world have a large influence on both the political process and economic policy. One of the largest challenges for investors today is that government policy is likely to determine the path taken by the domestic and global economy. This creates tremendous uncertainty because not only is it virtually impossible to predict what will be decided by legislative bodies, it can also be difficult to know what the ultimate effects of those decisions will be. Policymakers are deeply divided on how to approach the fiscal challenges in our vulnerable global economy.

For example, this summer we saw much debate and little progress on the U.S. fiscal deficit, as topics like tax policy and government spending continue to be very polarizing. The federal debt ceiling showdown was the quarter's most dramatic example of politics contributing to general uncertainty. Despite an 11th hour agreement that avoided a U.S. default (and put off the tough decisions to a later date), the contentious process and lack of meaningful action seemed to have a very negative impact on consumer confidence. These two factors were specifically cited by Standard & Poor's as part of the reason for their subsequent decision to downgrade the rating of U.S. debt from AAA to AA.



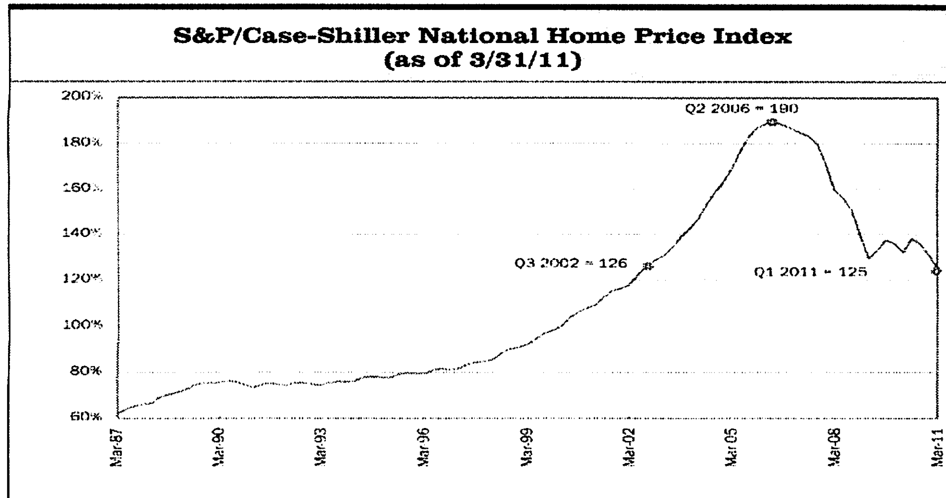
Source: International Monetary Fund, World Economic Outlook Database, April 2011.

Failure to meaningfully address the underlying causes of the country's annual deficits, which are currently running at approximately 10% of GDP, specifically federal "entitlement programs" such as Medicare, Medicaid, and Social Security, runs the risk of having the financial markets and our creditors force a solution on the issue. Investors would demand higher returns for taking on the risk of owning U.S. debt, forcing interest rates higher and reducing economic growth, not to mention raising the cost of paying the interest on our debt. This is precisely what has been unfolding with the European sovereign debt crisis in during the last year and a half.

With fiscal (spending) policy stalled by politics, monetary policy has been more aggressive and creative, with the Federal Reserve ("Fed") deploying a range of experimental tactics in attempts to boost the economy. After completing the second round of Quantitative Easing ("QE2") at the end of June, the Fed embarked on a new program in late September called "Operation Twist," whereby they will effectively exchange short-term bonds they own for long-term bonds in an effort to reduce long-term interest rates and encourage lending and investing. The Fed has also made an unusually explicit commitment to keeping rates low until at least 2013. Our view of monetary policy is that the problem is not overly tight monetary conditions and interest rates that are too high, but rather that we have stalled liquidity (also known as a "liquidity trap") as banks, corporations, and consumers hang onto their cash rather than spending or investing it in the U.S. economy.

A major piece of the domestic economy that is still suffering from the effects of a bubble during the last decade and the financial crisis is the residential housing industry. The S&P Case-Shiller National

Home Price Index has fallen to the lowest level since 2002 and the 35% decline from the peak in 2006 has been greater than the maximum decline during the Great Depression in the 1930s. Approximately 25% of the houses with a mortgage in the U.S. have negative equity (the mortgage principal owed is more than the estimated fair market value of the home) and it is estimated than over 40% of the homes in Massachusetts with a mortgage are "under water."



Source: S&P.

Domestic Deleveraging

Despite the increasingly heated rhetoric of recent months, little progress has been made toward bringing down the U.S. government deficit and debt. The compromise agreement that enabled Congress to raise the debt ceiling promised some deficit reduction, mostly coming after the 2012 election. However, the plan puts off the inevitable decisions regarding raising taxes, cutting entitlements, or some combination of both, without which the deficit will reach unsustainable levels in the not too distant future. To put it bluntly, the U.S. Government's balance sheet is in a shambles.

On a slightly more positive note, U.S. consumers have reduced their debt, although a significant proportion of that progress has come as a result of mortgage defaults and other debts (credit cards and other personal debt) being written off. Consumers need to further reduce their debt and this will be a drag on future economic growth because as consumers pay down debt and increase their savings they have less money to spend.

Corporations have made much more progress than consumers in deleveraging by paying down debt, refinancing their debt at lower interest rates, extending the maturity of their outstanding debt further into the future, and accumulating cash. In fact, corporations have more cash available as a percentage of their debt or assets than at any time since the end of World War II.

Debt and the Eurozone

European government debt problems are another issue with potentially huge ramifications for the economy and financial markets. Investors grew increasingly concerned about Greece in recent months but also, about the much larger economies of Spain, Italy, and France, as well as European banks due to their exposure to European government debt. We share the view of most experts that Greece cannot repay its debt without some kind of restructuring, which is a polite euphemism for default. The question comes down to whether it will be an orderly default, which can be managed in a

way that avoids a damaging contagion that brings down other governments and/or banks, or a disorderly one, in which case there would likely be another financial crisis.

The financial markets may essentially force a resolution to Europe's debt issues by driving up bond yields (and therefore funding costs) to a level that would push the weaker Eurozone nations (Greece, Portugal, Ireland) toward default and could also force Spain and Italy into a liquidity crisis and potential insolvency. The European Central Bank would likely step in to provide liquidity but, even with support, this scenario would result in a harsh economic shock at a time we can ill afford it.

China and Emerging Markets

Recently, questions about the quality and pace of China's growth have been more prominent as manufacturing has softened. We are concerned that China is experiencing unsustainable real estate growth and once the balloon is pricked, there will be a relatively sharp and quick slowdown in economic growth. It is also the case that China and other emerging markets are not immune to the economic slowdowns in the United States and Europe as these markets are key sources of demand for goods produced there. Recently, investors have seemed to recognize the potential for an economic slowdown as emerging-markets equities experienced a sharp sell off during the third quarter and have the largest losses of all equity assets on a year-to-date basis.

Third Quarter Investment Performance and Future Strategy

We are not short-term investors (speculators or gamblers). We have little confidence in our ability to forecast (guess) what will happen to interest rates or the stock market over the next few days, weeks, or months. And, we would certainly not make investment decisions based on those guesses. We do believe that over the long-term, economic fundamentals and equity valuations come to the fore and reflect the true value of a nation's and a company's productive efforts and assets.

Short-term thinking is what leads most investors to get whipsawed, chasing the market (or asset classes or fund managers) on the way up and then riding them down before jumping into the next hot asset class or manager. In other words, buying high and selling low - the path to investment failure. Conversely, we believe sticking with a process that has been successful over time, if not all the time, and using an appropriate time horizon to assess the success or failure of one's investment decisions is critical to winning the marathon of investing.

Over the past three months, two of our fixed income funds, PIMCO Total Return and Loomis Sayles Bond, have significantly lagged the Barclays Capital Aggregate Bond Index. PIMCO Total Return was positioned more for rising, not falling, interest rates. Loomis Sayles Bond, a higher-risk bond fund, has lagged by a wider margin as its partial allocation to lower-quality corporate bonds and foreign bonds has suffered losses. While we are not happy about the recent relative performance of these bond funds, we are not surprised by it. We fully anticipate that there will be periods of underperformance and we are willing to accept that in exchange for what we believe is a superior longer-term reward/risk tradeoff compared to the investment-grade bond index. More specifically, we believe our actively managed bond funds can generate at least low- to mid-single-digit returns over the next five years, while managing interest rate, credit, and currency risk. This contrasts with the investment-grade bond index, which has very poor return potential (likely 2% or less) and significant interest rate risk. Moreover, if we look back further than just the past few months we can see the value added from our selection of fixed-income managers. Over the trailing three, five, ten,

and fifteen year periods, our bond funds managed by PIMCO and Loomis Sayles have significantly outperformed the investment-grade bond benchmark. Don't evaluate your investments over a single period, particularly not a short-term time period.

In late July and early August, we reduced equity exposure in client accounts by 5-10%. We sold higher-risk stock funds such as small and mid cap domestic stocks and aggressive foreign equity funds that had performed well since the end of the global recession in mid 2009. While that marginally helped performance, it was not sufficient to overcome the underperformance of the bond funds mentioned above. We are currently waiting for an appropriate re-entry point to redeploy the cash back into lower risk equities such as higher yielding large cap U.S. equities and more conservative U.S. and foreign multinational equities that have significant exposure to the faster growing emerging market economies. We are also looking at some new alternative investment choices, such as high-yielding Master Limited Partnerships, and long-short equity funds, to further dampen volatility while providing good long-term returns above the broad market averages.

October 2011 Update

Concerns about sovereign debt problems in Europe that torpedoed stocks in the third quarter were replaced by hope and optimism that a European Union and Euro currency countries would reach a solution to the debt problem. Combined with generally good third quarter earnings reports from many bell weather companies, stock rallied sharply in October. U.S. large caps were up roughly 11% on the month and moved back into positive territory for the year-to-date period. Higher risk mid and small caps posted gains of 13-15%, although they are still in negative territory through the first 10 months of the year. Foreign developed markets stocks gained approximately 10% while Emerging Markets equities were up over 13%, although both groups are still showing losses for the year. Consistent with the risk-on/risk-off behavior in the market this year, lower quality bonds outperformed investment grade bonds during the month.

We remain cautious and defensive as the European sovereign debt problem is far from resolved. To quote John Hussman, manager of the Hussman Strategic Growth Fund:

> "... the EFSF (European Financial Stability Fund) is not actually an operating "bailout fund" at present - it's a shell corporation with a business plan and a certain amount of promised capital (not yet in hand) from European governments, in search of additional funding from private investors.
>
> In effect, European leaders have announced "***We have agreed to solve our debt problem, leveraging money we do not have, to create a fund, which will then borrow several times that amount, in order to buy enormous amounts of new debt that we will need to issue.***"

Furthermore, the U.S. Congressional "Super Committee" has a November 23rd deadline to craft a credible deficit reduction plan to present to the full Congress, which must then vote by December 23rd on the plan, otherwise automatic spending cuts will go into effect on January 1, 2013. Keep your seat belts fastened, folks, it's likely to be a very bumpy ride. Have a blessed and happy Thanksgiving!

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Index Returns for Period Ending 9/30/2011

	2011		Average Annualized Returns				
Equities and Equity Alternatives	**Q3**	**YTD**	**1 Yr**	**3 Yrs**	**5 Yrs**	**10 Yrs**	**15 Yrs**
US Stocks							
S&P 500 Index (US Large Caps)	(13.9)	(8.7)	1.1	1.2	(1.2)	2.8	5.2
S&P Mid Cap 400 Index (US Mid Caps)	(19.9)	(13.0)	(1.3)	4.1	2.2	7.5	9.5
S&P Small Cap 600 Index (US Small Caps)	(19.8)	(13.8)	0.2	0.8	0.3	7.4	7.5
Russell 1000 Index (US Large and Mid Caps)	(14.7)	(9.3)	0.9	1.6	(0.9)	3.3	5.4
Russell Mid Cap Index (US Mid Caps)	(18.9)	(12.3)	(0.9)	4.0	0.6	7.5	8.0
Russell 2000 Index (US Small Caps)	(21.9)	(17.0)	(3.5)	(0.4)	(1.0)	6.1	5.6
Russell 3000 Index (98% of US Stock Market)	(15.3)	(9.9)	0.6	1.5	(0.9)	3.5	5.4
Foreign Stocks							
MSCI EAFE Index (Foreign Large Caps)	(19.0)	(15.0)	(9.4)	(1.1)	(3.5)	5.0	3.3
MSCI EAFE Small Cap Index (Foreign Small Caps)	(18.6)	(15.5)	(5.5)	5.6	(1.9)	9.8	n/a
MSCI Emerging Markets Index (Foreign Emerging Markets)	(22.6)	(21.9)	(16.2)	6.3	4.9	16.1	n/a
Equity Alternatives							
FTSE NAREIT Equity REIT Index (US Real Estate)	(15.1)	(6.1)	0.9	(2.0)	(2.4)	9.2	9.1
Dow Jones UBS Commodity Index (Commodities)	(11.3)	(13.6)	0.0	(5.7)	(1.1)	6.0	4.2
Fixed Income and Cash							
High Quality Taxable Bonds							
Barcap 1-5 Year Govt/Credit Index (US Short-Term Bonds)	0.9	2.7	2.1	5.0	5.0	4.3	5.3
Barcap Aggregate Bond Index (US Intermediate-Term Bonds)	3.8	6.7	5.3	8.0	6.5	5.7	6.5
Barcap US TIPS Index (US Inflation Indexed Bonds)	4.5	10.6	9.9	8.1	7.1	7.2	n/a
High Quality Tax-Exempt Bonds							
Barcap Municipal Bond Index (US Tax-Exempt Bonds)	3.8	8.4	3.9	8.1	5.0	5.1	5.6
Low Quality Taxable Bonds							
Credit Suisse High Yield Index (US High Yield Bonds)	(5.1)	(0.5)	2.6	12.5	6.8	9.0	7.0
Cash & Equivalents							
3 Month US Treasury Bill (Cash)	0.0	0.1	0.1	0.2	1.6	2.0	3.0
US Inflation (Urban Consumers)							
US Consumer Price Index (US Urban Inflation as of 8/31/11)	0.7	2.8	3.8	1.1	2.1	2.5	2.5

The performance data shown represent past performance, which is not a guarantee or indicator of future returns.

The above data were gathered from sources known to be very reliable, however data accuracy is not guaranteed.