CORNERSTONE
Financial Management LLC

Economic and Financial Markets Review
2011 First Quarter
May 9, 2011

Highlights

- U.S. and foreign stocks moved higher in the first quarter in spite of political and social upheaval in North Africa and the Middle East, which contributed to sharply higher oil prices, and tragic natural disasters in Japan, Australia, and New Zealand.
- The U.S. economy continued its sub-par recovery, with real GDP growth of only 1.8% during the quarter. Growth in other developed economies was similarly lackluster.
- Intervention by the European Central Bank provided another financial rescue package, this time for Portugal. High levels of government debt and large annual deficits in the GIPSI countries (Greece, Ireland, Portugal, Spain, and Italy) have increased the likelihood that one or more of these countries will be required to "restructure" or default on their debt.
- Bonds posted slightly positive returns as price declines due to rising interest rates largely offset yields. Absent another recession, interest rates are likely to increase as the Fed ends its second installment of Quantitative Easing ("QE2").
- Sharply rising prices for oil and food continue to feed fears of rising inflation, particularly in the emerging economies and third world countries where food and fuel command a higher percentage of consumers' income than in the developed economies.

Investment Recap

In spite of a tragic earthquake, tsunami, and unfolding nuclear disaster in Japan, and political and social upheaval in oil producing countries in North Africa and the Middle East, US stocks continued their upward march in the first quarter by gaining 6-8%. Foreign stocks posted positive returns as well, although in a lower range of 3-4%. Real estate and commodity returns were in-between those of US and foreign stocks. US high-quality bond returns were barely positive in the first quarter, with the exception of inflation-linked bonds such as Treasury Inflation Protected Securities (TIPS) which moved higher on the back of rising inflation.
Lower quality, high yield ("junk") bonds returned nearly 4%, while cash returns continued to be essentially zero. Please refer to the Index Returns table at the end of this letter for further details.

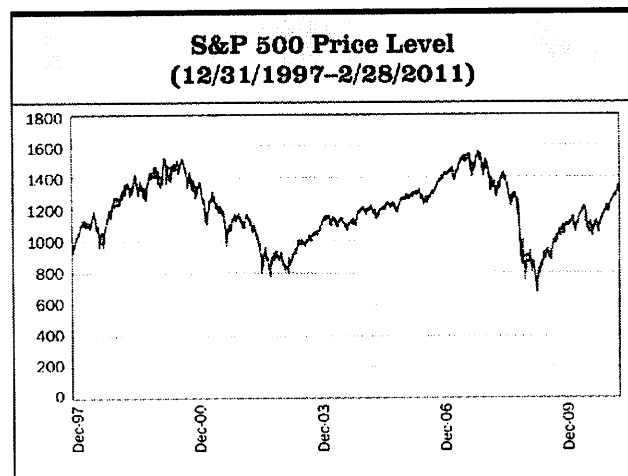

Chart 1: Stocks have gained little ground over the past 13 years.

Stock Returns—Why We Remain Somewhat Defensive

For most of the last 13 years, US large cap stocks have posted very modest returns because they have largely moved within a trading range between 800 and 1500 as seen in the price chart for the S&P 500 Index to the right (chart 1). Our analysis and conference calls with investment managers lead us to be cautious regarding future returns for US stocks. We continue to see an unusually wide range of possible outcomes for the US economy and stock market. The weight of

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the evidence continues to suggest that stock returns for the next 5-7 years will be below the historical average, and as a result, we remain somewhat defensive.

Stocks are the primary asset class for taking on risk. So when expected returns from stocks are not attractive, we are likely to be cautious. To understand the potential upside for stocks, we need to look at the important factors that drive stock returns: dividends, earnings growth, and changes in valuations (the price/earnings ratio and other metrics).

Today, stock **dividend yields** are very low when compared to the last 50 years (see chart 2). Currently, the S&P 500 yields about 1.8%. Compare this to the 25-year average of 2.3% and the 50-year average of 3.1%. In the past, secular (long cycle) bull markets for stocks have always begun with higher-than-average dividend yields. Since 1926, the only time the dividend yield was lower than it is now was during the period of elevated stock valuations in the late 1990s and early 2000s.

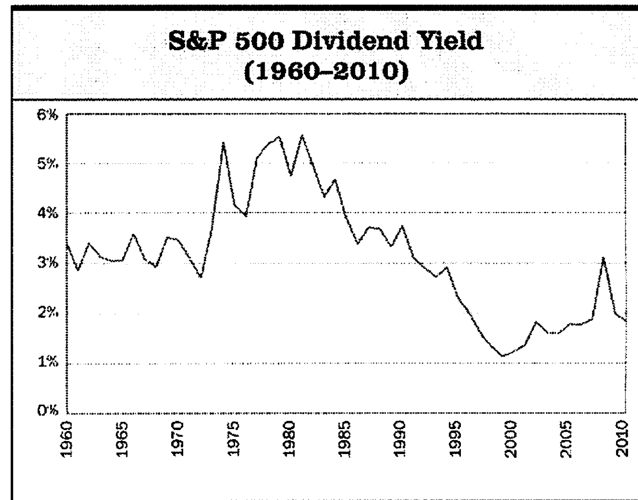

Chart 2: Dividend yields, one component of equity returns, are below their historical average.

Earnings growth is more challenging to assess and forecast. Historically, over very long periods of time, corporate earnings growth has roughly tracked nominal GDP growth as seen in chart 3. It is also apparent from the chart that earnings are much more volatile than GDP and that earnings volatility has increased over time. Earnings have rebounded powerfully since the very deep trough in 2009 that coincided with the "Great Recession." This rebound has been driven by cost cutting and government stimulus, neither of which will be sustained over the long run, and the growth of the emerging markets, which is more likely to be sustained. Subpar economic growth is consistent with historical outcomes in the aftermath of a financial crisis. The excessive private and public debt cloud hanging over the economy will result in continued deleveraging and therefore a lower level of consumption than would otherwise be the case. Private debt has declined from its peak but remains historically high, while government (public) debt has spiked higher and will continue to increase given growing entitlement costs as the "Baby Boomers" age. Increased regulation and the likelihood of higher taxes also could challenge growth. So could unexpected economic events—such as growing instability in the Middle East, which triggered a rise in the price of oil, and the tragic natural disasters in Japan, New Zealand, and Australia.

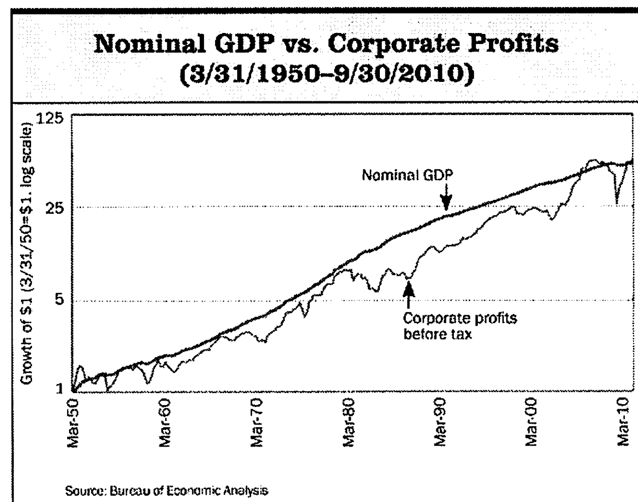

Chart 3: Earnings growth tracks GDP growth over the long term.

Changes in stock valuations (P/E multiples) can be affected by a number of factors, including expectations for future growth, the level of interest rates, inflation rates, and investor sentiment or psychology. Government stimulus and the Fed's quantitative easing program ("QE2") are scheduled to wind down in coming months, and without the private sector ready to accelerate into a more normal recovery mode, economic growth is likely to remain sub-par. Unemployment has also remained very high, depressing consumer spending and the residential housing market. Recently, inflation has accelerated, including spikes in prices for food and energy. This has led to increases in interest rates in emerging market economies (China, India, and Brazil among others). In addition, some investors think US interest rates may increase after the Fed's "QE2" policy of buying US Treasury securities ends on June 30th because the Fed has purchased up to 70% of all the new Treasury debt issued by the US government.

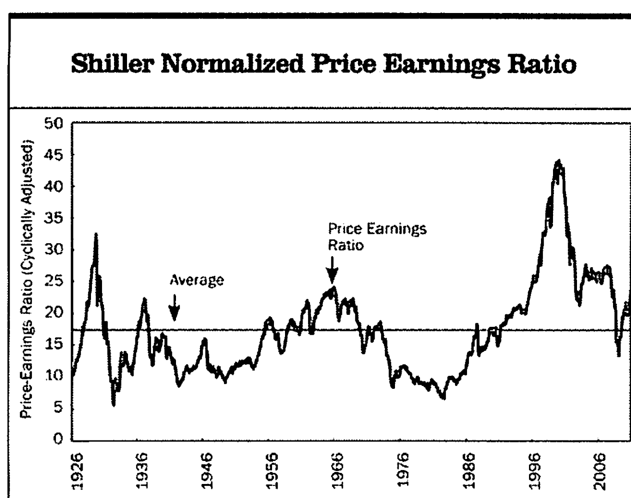

Chart 4: Except for the periods encompassing the tech and real estate/debt bubbles, the only other times the P/E has been this high was in the late 1920s and mid-1960s. Both periods preceded long and deep bear markets.

Stock valuations (chart 4) are currently above the long-term average, so we should not expect much or any improvement in stock valuations as was the case from 1982-1999 when we went from a below average Price/Earnings (P/E) ratio to an historically high P/E ratio during the technology bubble in the late 1990s. In addition, corporate profit margins are currently near all-time highs. Historically, profit margins have had a very strong tendency to revert to their long-term averages, so if history repeats, profit margins are not likely to remain as high.

All of these factors roughly net out to a likely annualized return for stocks in the low to mid-single digits, roughly 3-6% per year.

In our view, the European equity markets are similar to those in the United States with respect to overall fundamentals and return potential. Europe continues to struggle with its own debt crisis and economic challenges. The single currency greatly complicates policy management for a group of countries with entirely different economic fundamentals - a powerful Germany at one extreme and debt-plagued Greece, Ireland, and Portugal at the other.

Investment managers that we follow and respect believe emerging market equities will generate higher returns than developed market stocks over the next 5-7 years, but with potentially higher short-term volatility. All of the foreign equity funds that we utilize in client portfolios have significant exposure to emerging markets – generally between 10-30% depending on the specific fund and how conservative or aggressive an investment strategy the manager is employing. The growing inflation risk and rising interest rates in emerging markets, however, have resulted in emerging market stocks underperforming since late last year. If growth in the emerging economies were to slow significantly, this would not be a positive development for the large multi-national companies headquartered in the US and Europe. We could also be underestimating the risk that inflation might spike considerably higher, driven by rising commodity prices due to emerging market demand, further disruptions of oil supply, and by government policy that is left with no choice but to inflate away the debt problem rather than implement politically unpopular tax increases and spending cuts.

Building Intelligently Diversified Portfolios in a Highly Uncertain World

Given the level of macroeconomic risks facing a highly indebted developed world, our goal is to build portfolios that can perform reasonably well in most environments, and mitigate losses in more severe scenarios. Therefore, we are going to be taking the following steps in the next 3-6 months to further reduce risk and position client investment portfolios more defensively:

1. Rebalance and/or trim back overall equity exposure toward the lower end of the target asset allocation range we are using for your portfolio. Emphasize dividend paying stock funds.

2. Emphasize the highest quality stock funds in terms of the valuation metrics used to measure the quality of the companies owned by the fund. Reduce or eliminate holdings in lower quality or very risky stock funds.

3. Increase exposure to fixed income and cash alternatives toward the upper end of the target asset allocation range we are using for your portfolio.

4. In spite of some high profile headlines predicting massive municipal bond defaults, we will continue to use municipal bond funds for clients because in many cases their yields before taxes are higher than corresponding taxable government bonds and they offer tax-exempt income at the federal and sometimes the state level. We will also stick with those funds that emphasize the highest quality bonds and avoid troubled state and local issuers.

5. Add bonds funds outside of the typical government and municipal investment grade bond funds we would normally use to reduce investment risk because of the unusually low yields for these bonds as a result of current Fed policy. Examples would include floating interest rate funds, funds investing bonds from emerging economies that have good growth and low levels of debt, and flexible or absolute-return oriented funds.

6. Increase exposure to inflation-indexed bonds and commodities that will outperform if we experience a period of rising inflation.

7. Increase or add to funds that use low risk strategies to generate generally positive returns such as arbitrage and/or hedging.

Maintaining a Margin of Safety

To use a metaphor from the world of running, investing is a marathon, not a sprint. We are investors over a lifetime and during our investing lives there will be periods when it pays to be conservative and others when it makes sense to be aggressive. What motivates us to take more investment risk are the prospect of very good returns and the presence of a margin of safety. Today we do not believe there is an adequate margin of safety in the broad stock market. Valuations are not attractive enough to compensate for the many concerns mentioned above. There is also an insufficient margin of safety against risks we may not be anticipating. And if there is a return to recession, it could trigger very nasty problems given where the US currently is with respect to debt, deficits, and unemployment.

Even without worries about oil and food prices, or the possibility of unexpected economic shocks, risky assets are not currently priced to offer enough reward given the above-average risks we see as the world seeks to deleverage after decades of expanding debt. In this environment, we will transition to a posture of below-average risk exposure because we think that is the prudent course of action.

Cornerstone Financial Management LLC

Index Returns for Period Ending 3/31/2011

	2011	Average Annualized Returns				
Equities and Equity Alternatives	**Q1**	**1 Yr**	**3 Yrs**	**5 Yrs**	**10 Yrs**	**15 Yrs**
US Stocks						
S&P 500 Index (US Large Caps)	5.9	15.7	2.4	2.6	3.3	6.8
S&P Mid Cap 400 Index (US Mid Caps)	9.4	27.0	10.0	6.1	9.4	11.6
S&P Small Cap 600 Index (US Small Caps)	7.7	25.3	8.4	3.7	9.2	9.7
Russell 1000 Index (US Large and Mid Caps)	6.2	16.7	3.0	2.9	3.8	7.1
Russell Mid Cap Index (US Mid Caps)	7.6	24.3	7.3	4.7	8.5	9.9
Russell 2000 Index (US Small Caps)	7.9	25.8	8.6	3.4	7.9	7.8
Russell 3000 Index (98% of US Stock Market)	6.4	17.4	3.4	3.0	4.1	7.1
Foreign Stocks						
MSCI EAFE Index (Foreign Large Caps)	3.4	10.4	(3.0)	1.3	5.4	4.7
MSCI EAFE Small Cap Index (Foreign Small Caps)	3.0	19.9	1.4	1.4	10.5	n/a
Equity Alternatives						
Dow Jones US Select REIT Index (US Real Estate)	6.7	24.4	1.5	0.7	11.3	11.1
Dow Jones UBS Commodity Index (Commodities)	4.5	28.5	(5.2)	2.6	7.1	6.1
Fixed Income and Cash						
High Quality Taxable Bonds						
Barcap 1-5 Year Govt/Credit (US Short-Term Bonds)	0.3	3.1	3.7	5.1	4.6	5.3
Barcap Aggregate Bond (US Intermediate-Term Bonds)	0.4	5.1	5.3	6.0	5.6	6.2
Barcap US TIPS (US Inflation Indexed Bonds)	2.1	7.9	3.9	6.3	6.7	n/a
High Quality Tax-Exempt Bonds						
Barcap Municipal Bond (US Tax-Exempt Bonds)	0.5	1.6	4.5	4.1	4.7	5.3
Low Quality Taxable Bonds						
Credit Suisse High Yield (US High Yield Bonds)	3.8	13.6	11.7	8.5	9.0	7.7
Cash & Equivalents						
3 Month US Treasury Bill (Cash)	0.0	0.2	0.4	2.1	2.1	3.2
US Inflation (Urban Consumers)						
US Consumer Price Index (US Urban Inflation)	1.0	2.1	1.4	2.2	2.4	2.4

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