Cornerstone's Investment Letter

Cornerstone Capital Advisors First Quarter 2011

Quarterly Investment Commentary

Our portfolio allocations are being positioned somewhat conservatively, and there are a few important points to make in this regard.

Our longer-term analysis suggests that stock returns are likely to be mediocre.

Likely returns from bonds are even lower than stocks.

As a result, we are underweighted to stocks and bonds in favor of fixed-income and alternative strategies that should offer competitive returns at less risk.

Things could turn out more positive than we expect, but even if they do the underlying problem of too much debt can't be fixed without hurting economic growth.

Stocks continued their upward march in the first quarter, with large-caps gaining almost 6%, while mid and small cap stocks posted gains approaching 8%. Overseas, returns were not as strong, though still good. Developed-market foreign stocks were up more than 3%, while emerging-market equities gained just under 2% for the quarter. Domestic high-quality intermediate-term bonds didn't fare as well, barely gaining ground in the first quarter, while foreign bonds did a bit better, with developed-market government bonds gaining 0.7% and emerging-market bonds climbing by almost 3%.

We Are Cautious

For various stretches over the last 13 years we have been cautious towards the stock market based on our assessment of market valuations and expected returns. This has frustrated our clients at times (the late 1990s being the most notable example) as the S&P and NASDAQ rocketed higher during the late stages of the tech bubble. Our caution proved to be warranted.

As we reflect back and look forward, there are several points worth emphasizing.

1. Our valuation-driven, scenario-based approach is designed to help us make good decisions over the long-term. We know we can't predict the short-term with consistent accuracy.

2. Even in the midst of long periods where returns are low there are still opportunities. In fact, these low-return periods are often characterized by higher volatility that can offer occasional fat pitches in "risky" asset classes like equities, REITs, and high-yield bonds. We have been able to take advantage of "fat pitches" in previous market cycles and they have contributed significantly to our returns.

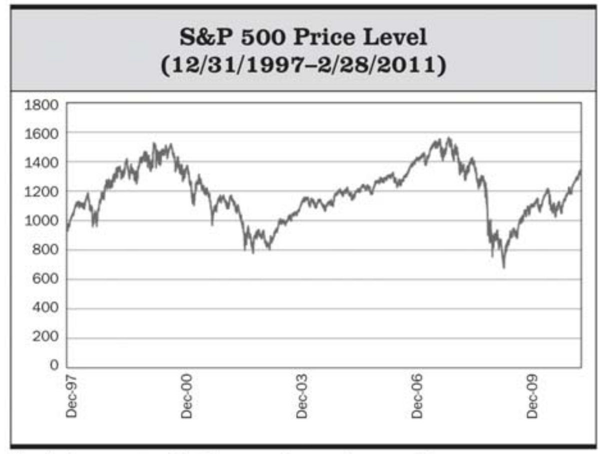
Currently, we are positioning our portfolio allocations more conservatively and there are a few important points to make in this regard.

First, our longer-term analysis suggests that stock returns are likely to be mediocre over our five-year time frame - most likely somewhere in the low to mid single-digit range. We analyze return ranges for stocks by considering the possible economic scenarios we could see, and then considering how the “building blocks” of equity returns - dividends, earnings growth, and multiples - stack up under each. A challenge is that the range of possible outcomes is unusually wide, ranging from another recession to a return to the “old normal” patterns of borrowing and spending. We believe the odds skew towards the more negative outcomes, and this impacts how we want to allocate our portfolios.

Second, we expect returns from bonds to be even lower than stocks. With interest rates quite low, and longer-term inflationary pressure likely to result from our government’s fiscal policies and challenges, it is far more likely that we will see rising rates (which push bond prices lower) than falling rates over our investment horizon. Without the tailwind of falling rates, and with yields on bonds starting at low levels, we expect only very low single-digit returns from core high-quality bonds. Ordinarily, if we believe equity returns are likely to be higher than bonds, it would argue for being overweighed to equities to capture that higher return.

That brings us to our third point, which is that with low expected returns for stocks and bonds, *and* with significant big-picture risks out there that could damage returns (especially in the shorter-term), we are moving to be underweight to both stocks and core bonds in our balanced portfolios in favor of investments that we think collectively offer better or at least competitive returns with hopefully less risk.

Examples of portfolio positions that we believe offer a better risk-reward tradeoff include: Floating rate funds that generate good yields but that are not exposed to the risk of rising rates, and arbitrage strategies that are able to earn a return without the tailwind of rising stock prices. We have two other fixed-income investments that come with a notch-higher risk than the investments described above, but that similarly offer better bang for our risk buck. The multi-sector Loomis Sayles Bond invests in (among other things) carefully selected high-yield bonds and foreign bonds, mainly of commodity producing countries, which provides some hedge against a falling dollar. The other fund, PIMCO Emerging Local Bond, invests in the bonds of emerging-markets countries and is a more direct-dollar hedge. It offers an attractive 7% yield and the chance for greater currency appreciation if our longer-term assumptions that the dollar will decline prove correct.



Stocks have gained little ground over the past 13 years.

These investments are generally a little riskier than core bonds in that they would provide less protection from a severe downside scenario such as recession or deflation, but we believe they are significantly less risky than equities. Since these positions are or will be funded from reductions in both stocks and bonds, the intended net effect of these positions is to reduce overall portfolio risk while generating as good or better returns in most scenarios.

Our core investment-grade bond exposure will continue to be achieved mostly via PIMCO Total Return. As you might have recently read, this fund has sold 100% of its U.S. Treasury investments.

We are often asked: "What if you are wrong and stocks just keep going up"? Stocks can keep going up in the shorter-term, and this is not something we are confident in our ability to predict. But over the longer-term, which we can analyze with more confidence, an important driver of stock returns will be earnings growth, and this is highly correlated to the overall economy. So could the economy perform well enough to continue to drive the kinds of stock returns we've been seeing? Consumers could ramp up spending, and take on more debt, and the jobs and housing pictures could improve more quickly than we expect. But even if that happens to some degree, the deepest underlying problems aren't going to go away as a result.

The deeper problem is that we have gone through a massive build-up of debt that occurred over many decades, and a lot of it still remains. Some of it has effectively been shifted to the government. With large deficits, a growing national debt, and entitlement spending on track to make these problems significantly worse over coming years and decades, it is inevitable that at some point as a nation we will have to take our medicine. When we do, it will mean we borrow less and spend less, which will reduce economic growth, and that will be a drag on corporate earnings and therefore stock returns.

It is in considering the headwinds the economy faces in the years ahead, and factoring in other big-picture risks such as Europe's debt problems, unrest in the Middle East, Japan's disaster, and other possible shocks we can't foresee, that we conclude that the returns stocks are likely to earn aren't sufficient to compensate us for overweighing equities. We've often said that we view investing as a marathon - not a sprint. We all are investors over a lifetime and any one year is a small slice of our investment timeline. Over our investing lives there will be periods when it pays to be conservative and others when it makes sense to be aggressive. Sometimes these periods will be short, other times they will last for years. Along the way there will be ups and downs within each of these periods. Our challenge is to ignore the ups and downs and focus on the potential returns we believe we can capture and weigh them against the risks.

Ultimately, what drives our risk-taking is the presence of a margin of safety, i.e., a significantly undervalued asset, such that even in a bad scenario it shouldn't have much downside. Today we believe there is an inadequate margin of safety in the stock market. Valuations are not attractive enough to compensate for the many serious concerns we've mentioned that could impact investment fundamentals. And because we have other investments that can generate competitive returns at less overall risk, we are not concerned that over the longer-term we are giving up a lot of opportunity even if we see a scenario that is better than we expect.

Meanwhile, it is worth noting that despite our equity underweight, our net "risk underweight" is less than it seems because many of the investments described carry higher risk than bonds, from which they are partly funded.

We are confident that inevitable periods of fear will drive certain asset classes lower and present us with opportunities to earn much more compelling returns in exchange for ratcheting our risk higher. This discipline and longer-term focus, along with careful underlying research, is the core of what we bring to the table as investment advisors.

Cornerstone's Research Team (4/11/2011)