<u>For Cornerstone Clients</u>: Clients will receive their annual holdings and performance reports over the next few weeks as we receive year-end reports from the underlying managers. However, we wanted to send out our newsletter in advance as an outlook for 2013.

Market Overview

The S&P 500 declined -0.4% for the fourth quarter, but increased 16% in 2012. The good news is that economic data has taken a turn for the better, despite political headwinds and gridlock. There are a number of recent positive indicators for the economy including consumer spending, capital expenditures, and financial investment. Oil prices are down. Europe appears more stable. The housing sector in the U.S. is improving. Real GDP in the third quarter was revised up to 2.7%, and inflation remains low. Household net worth increased by $1.7 trillion in the last quarter, and is closing in on the previous peak in 2007.

However, other indicators are moving slower and sending mixed messages. We believe we will continue to be in a high-risk, low-growth environment. Individuals continue to move out of the job market as they lose hope of employment. A lower unemployment rate due to individuals leaving the job market is a sign of continued job weakness, and is not positive for future economic growth. If the job market picks up steam, we would expect an increase in the unemployment rate as more people enter the job market looking for a job. That would actually be a positive sign for the economy if the job market is improving. Corporate revenues and profit growth have been slowing for several months. As we enter the corporate earnings season, we will be watching very carefully how many companies continue to revise downward their earnings estimates, an event which became popular starting last summer.

After considering Europe's debt crisis, China's slowdown, Japan's struggles, and the U.S. GDP starting under 2%, the market fared much better in 2012 than most would have predicted. Although the Congressional compromise solution was achieved after year-end, the very same participants are already waging war on each other over the next battle, the U.S. debt ceiling. President Obama has said that he will not debate Congress to pay the costs of legislation that it's already passed into law. He also mentioned that he will be looking for additional tax revenues down the road. The GOP Senate Leader, Mitch McConnell, has stated that the debate over taxes is done with, and the only matter to debate is spending. As you can tell, this will not be a friendly debate. We believe that this debate could even be uglier than the fiscal cliff debate. If a compromise can be reached, we believe 2013 could be a good year for many asset classes as the economy has weathered the gridlock so far. However, if gridlock in Washington entangles the economy for a few more months, the stock market could quickly correct off its current five-year highs.

The "Fiscal-cliff" Notes

Below are some of the key provisions of the "Fiscal-cliff" deal signed at the beginning of the New Year. The legislation allowed some of the Bush-era tax rates to expire while maintaining others; it modified capital-gains and dividend tax rates for some taxpayers; and, adopted a few other provisions.

- <u>Income-tax rates</u>: The maximum rose from 35% to 39.6% for individual incomes over $400,000 and households over $450,000.
- <u>Investment taxes</u>: Capital-gains and dividend taxes increased from 15% to 20% for the same bracket as above.
- <u>Payroll taxes</u>: The payroll tax on the first $113,700 in wages increased from 4.2% to 6.2%. We believe this tax will have the largest negative impact on the economy as this will be deducted from payroll checks immediately.
- <u>Estate Taxes</u>: The estate-tax exemption is $5 million and will be indexed to inflation moving forward. Taxes above this amount will rise from 35% to 40%.
- <u>Alternative minimum tax (AMT):</u> The tax will be permanently adjusted for inflation.
- <u>Itemized deductions</u>: Filers earning more than $250,000 singly or $300,000 jointly will be limited in personal exemptions and itemized deductions.
- <u>Sequestration</u>: The automatic spending cuts were postponed by only two months.
- <u>Family credits</u>: The Child Tax Credit and Income Tax Credit are extended for five years.

Knowing that the fiscal cliff deal was not a permanent solution or even a great short-term solution, the more important question to ask is probably which side of the argument lost its leverage by the recent negotiations. It was clear that taxes were the main focus of the recent gridlock. We believe that spending will have to be the main focus of the next round of negotiations. This probably means meaningful spending cuts in governmental and entitlement programs. Although we agree spending cuts are essential to the long-term viability of the U.S., there will be short-term economic consequences. However, as we have believed that uncertainty has been one of the biggest impediments to economic growth, we believe that the U.S. market place can deal with whatever changes may come as long as the companies and individuals have certainty and can plan for it. This includes higher taxes and smaller government.

Market Outlook

Below are a few bullet points from our outlook heading into 2013. Overall, they have not changed much from the last newsletter, but we have added a few additional comments.

- Ben Bernanke will continue to backstop the equity markets. The printing of easy money will continue, but it will be less effective than previous attempts at stimulating the economy. Just last week, it was noted in the notes of the last Federal Reserve Board meeting that several members are worried about keeping interest rates too low for too long. We believe the expectations of inflation could drive asset class performance in 2013 even more than if inflation actually occurs.

- U.S. GDP will continue to stall around 2% into 2013 which means unemployment will not drop significantly. When the job market begins to gain steam, we would actually look for an increase in the unemployment rate as prospective employees reenter the market. The main driver of the decreasing rate in 2012 was participants in the job market who stopped looking for a job, and therefore no longer counted as unemployed. So if the unemployment rate goes back in 2013, it could be good news if it's because more people are looking for a job.

- Bernanke stated he plans to keep interest rates low through 2015. Negative real returns for investors should bode well for hard assets such as precious metals and real estate.

- Currencies will play a bigger role as the Fed wants to weaken the dollar, but the crisis in Europe could maintain the Dollar as a safe haven investment. A strong dollar will also have negative effects on U.S. companies because it will lower reported revenues from foreign countries.

- Housing has bottomed in many areas which will be a positive for the economy. The housing sector has also seen many improvements over the last six months. We expect a saucer recovery in most areas, but some areas that currently only have 1 or 2 month supply will recover much quicker. We believe housing could be the biggest story of 2013 if it continues to improve as it could positively affect the unemployment rate, increase consumer spending, and increase sentiment as fewer homes would be underwater.

Investment Outlook and Strategy

Using the above as our backdrop, below are a few thoughts on different asset classes that affect our current allocation strategies. In the current environment there are significant headwinds as well as potential catalysts we feel could improve the economy if Congress would act responsibly. We continue to maintain a diversified investment strategy that attempts to protect portfolios against the known and unknown risks facing investors.

Bonds- As we noted in the last newsletter, the upside of bonds has decreased substantially in the last year (how much lower can rates go, right?). However, we still believe in most regards that it's useless to fight the Fed. In this environment, we also see advantages of using managers which have the ability to go where the opportunities are. In many portfolios we have moved to a multi-sector bond fund which offers more of the flexibility the current environment demands, rather than a core bond fund. Specific to California, in 2012 investors felt the risk of owning State of California bonds has diminished. Len Templeton, one of our bond managers, believes, "…this trend is likely to continue this year. We like to buy good local school district G.O. bonds, essential service revenue bonds, sales tax revenue bonds, and some good quality hospital bonds for our California clients. We avoid most city bonds and pension bonds, because we are concerned about credits with exposure to unfunded pension liabilities."

High-yield Bonds- This asset class continued to be an outperformer in 2012, up almost 16%. As companies have piles of cash sitting on their balance sheets, default risk remains low. This asset class has seen an increase in inflows, but continues to perform well. Yields on many income-producing investments including utilities, high-yield bonds, MLPs and REITs have decreased as values have soared from investor demand. We see high-yield bonds as a good diversifier to stocks in the current environment. If a client wants to take on more risk, but remain out of the stock market, we still believe high-yield remains a good area. We also believe this is a great opportunity in the private market. Last year we started working with Keystone, whose strategy is to replace banks that are no longer willing to lend. With opportunities of strong cash flow backed by great collateral, we feel there is a great risk/reward investment.

Stocks- Managed and active funds lagged in 2012 as "risk on" and "risk off" days made managers cautious. As we look to 2013, we believe the first quarter could be sideways or have a small correction if corporate earnings fail to impress or if gridlock consumes Washington. We are more optimistic for the second half of the year. We hope that Congress will provide more certainty which will allow businesses to plan and invest for the future. However, any corrections in the first half of the year may be an opportunity to buy in for a long-term investment horizon. The stock market is not expensive in historic context, and with emerging markets playing a larger role, growth potential is there although there are headwinds. We believe that emerging markets may be an area of opportunity for 2013 as developing countries continue to have better fiscal policies. Emerging markets should also benefit from a more stable Europe and U.S. As well, if bonds become less desirable due to rates inching up, stocks should benefit from money moving away from bonds.

Real Estate- The multi-family housing sector saw a lot of investor money come in to acquire assets in 2012. This bodes well for us, as many clients have invested with Virtu over the last two years in the space. Virtu was able to sell one property this summer, is selling one in January, and we hope that the continued recovery in this space will allow them to sell other properties that they managed during the downturn. Virtu expects to sell individual properties that it acquired before it launched it fund, but also a few assets in its first fund. With another investment that we started last year, Omninet, an improved economy will help increase rents and distributions to owners. We still think real estate presents a great investment opportunity as well as diversification from the stock market. Specifically, we think the opportunity to generate cash flow favors this real estate sector in particular. As inflation expectations increase, this asset class could do well if property values increase and rents move upward.

Commodities/Managed Futures- Over the last twelve months these asset classes have been the biggest drag on clients' portfolios. The "risk on/risk off" mentality of the markets is not conducive to great performance in managed futures which wants to follow trends whether up or down. The last six months has been a great example, as commodities were the best performer for the third quarter, but quickly reversed to the worst performer in the fourth quarter of all the asset classes. Although the managed futures and commodity exposure has decreased a little, mostly due to negative performance in 2012, we continue to use these asset classes to mitigate the risks of increased inflation expectations and a weakening dollar while the Federal Reserve continues printing money at historic rates.

Overall, if the economy stays weak, we expect bonds and other income investments to remain desirable and overvalued in 2013. Borrowers gain the benefit of low interest rates, but those living off fixed income face challenges in the current environment. If the economy begins to gain steam in 2013, these same investments will have lower valuations and assets such as stocks and commodities should benefit.

Cornerstone Team Notes

Cornerstone's 5th Annual Holiday Open House

Chris and Lesley Meacham graciously hosted a holiday open house in their beautifully decorated home on December 13, 2012. We all enjoyed sharing the season with our wonderful clients and friends. If you missed it, we hope to see you next year. The food, music and magician were all great! Pictured are clients Dennis and Leigh Ann Naas, newest members of the Cornerstone family.

Rancho Santa Fe Office Opening

We are pleased to announce the opening of an office in Rancho Santa Fe to better serve our clients. We invite you to stop by whenever you are in the area. Please plan to join us in April for the official Open House. Details will be available soon!

6105 Paseo Delicias, 6-C
Rancho Santa Fe, CA 92067

ElliptiGO World Championship and 100-mile Race

This fall Scott Bramwell participated in the ElliptiGO World Championship up Palomar Mountain, a climb of 4,200 feet over 11.7 miles. Scott also joined the century club for ElliptiGO, completing a 100-mile race in one day.

Investment Travels

Ross Bramwell was busy in the fourth quarter visiting a few of our investment managers including:

- Steben & Co.'s annual Due Diligence conference in San Francisco, CA. Steben manages a portfolio of underlying trend-following, systematic or contrarian managers that invest in managed futures.
- Keystone National Group in San Ramon, CA and visited with John Earl. Cornerstone started to invest through Keystone in 2012. John spoke at our Cornerstone Diversified Portfolio, LP semi-annual meeting this fall, and will most likely speak again at one of our monthly roundtables in the near future.
- While in the Bay area, Ross also visited with two real estate groups, Virtu and Landsmith, and discussed the current real estate holdings of Cornerstone clients and also future opportunities.