MODEL PORTFOLIO *FOR INCOME*

Securities offered through Cantella & Company, Inc., Member, FINRA, SIPC

Cornerstone Model Portfolio *For Income*

Today, income investors face new and different challenges. With interest rates near lows not seen in 50 years, investors are clamoring for yield. Many are making risky bets in search of high yields by buying junk rated bonds and extending maturities. Attracted to high yields, many investors are setting themselves up for failure with the wrong investments in a rising interest rate environment.

This is why Cornerstone has developed the **Model Portfolio for Income**. It is a way to help investors get the income they need while positioning their assets in such a way that may benefit from rising interest rates.

Index

Two Enemies of Income..................................1

Economic Outlook...2

Strategy..2

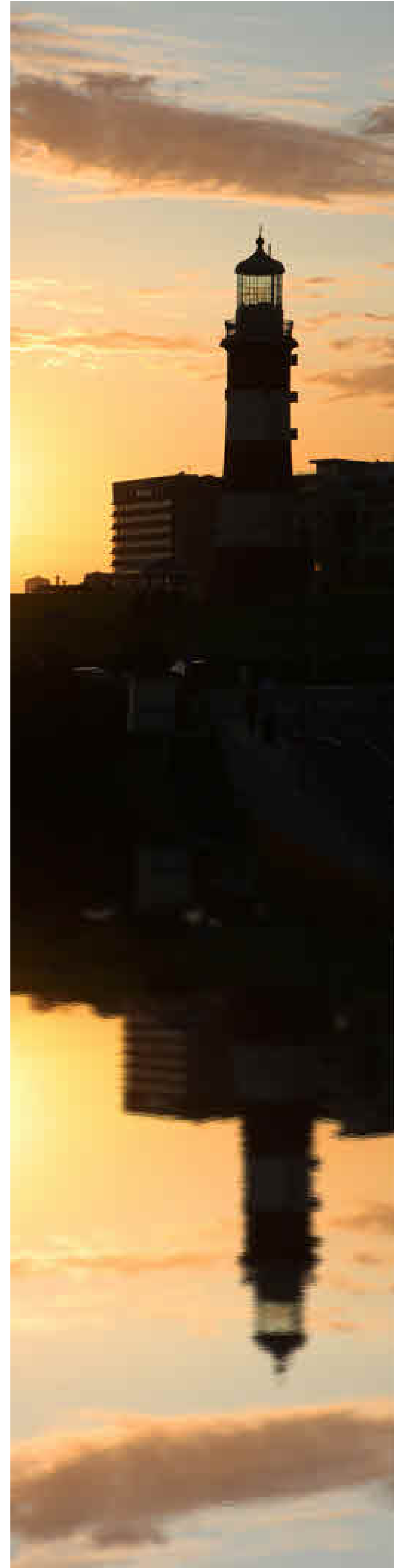
Investments to Avoid......................................3

Investments We Currently Utilize.................4-6

Flexible Asset Allocation..................................7

Conclusion..7

Disclosures...8



Two Enemies

Income investors have two major enemies. The first is inflation and the second is rising interest rates.

Inflation devalues the income received as it marches forward. A 10 year bond pays a fixed amount of interest each year. But inflation keeps rising, so the income received in the first year may only buy one half of the goods and services it will in the tenth year, due to inflation and prices rising.

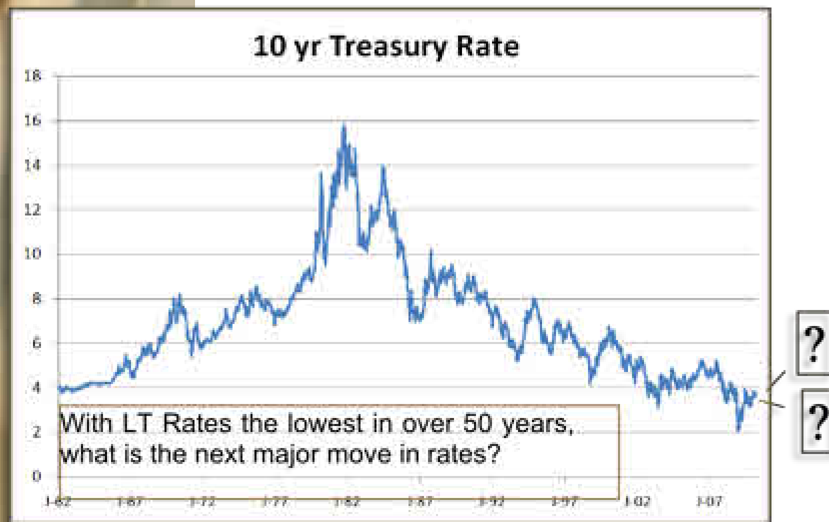
Rising interest rates can depress an investment portfolio focused on income. Interest rates and bond prices have an inverse relationship. As one rises, the other declines. (This applies to pricing of bonds on the secondary market. If held to maturity, most bonds mature at face value.) Here's how it works:

A hypothetical example of this would be if you were to buy a bond for $10,000 due in 20 years. It has a 5% coupon rate. But a couple of years later, rates climb to 7%. Wanting the higher rate, you plan to sell your bond and buy the higher rate bonds. But you can't. Your bond is no longer worth $10,000. It is worth about $8,100 on the secondary market.

This is because of Yield to Maturity (YTM).

Current interest rates force all other bond sectors into a relative equilibrium between price and current yield. (Equilibrium is based on ratings, duration, etc, described later in this report.) If rates have gone up, bond prices come down. If rates go down, bond prices rise.

This is because of the way the market works. Why would anyone pay full price for a bond yielding 5% when current new bonds yield 7%? So in order to entice buyers, sellers have to drop the price for the bond until it hits an equilibrium price, the YTM.



Source: Yahoo! Format: CIS

Conversely, if a seller has a bond yielding 7% when the prevailing rate for similar bonds is 5%, he can demand a premium, or higher price for his bond.

With interest rates having been declining for almost 30 years, now lower than they were 50 years ago, what direction should investors expect rates to go? Is it logical to assume rates will go lower, or is the next major move higher?

Our research shows rates should start to head higher in the coming years, much higher.

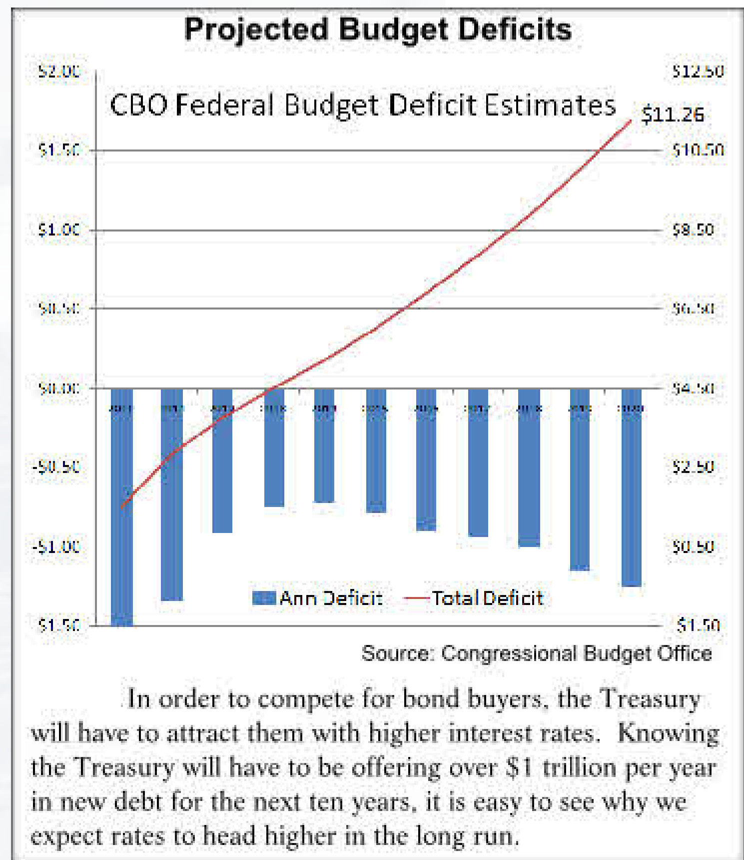
Economic Outlook:

The driving force behind our economic outlook is the deteriorating fiscal condition of the Federal, State and Local governments. In order to bail out the economy in 2008/2009, and keep it going into the future, the Federal government has put the US on a dangerous path. According to the Congressional Budget Office, Federal Budget Deficits are expected to total almost $3 trillion in the next 2 years.

Deficits are expected to stay high for the next ten years, still over $1 trillion per year in 2020. With
the passage of the Healthcare Reform, an estimated $1 trillion more will be added to the deficits over the next several years, making the average Federal Budget Deficit over $1 trillion per year for the next 10 years.

Frightening as this sounds, now is not the time to bury your head or run in fear. Now is the time to make plans and set yourself up to benefit from what the government is doing instead of being a victim.

With these deficits will likely come much higher interest rates, rising inflation and a declining US Dollar. None of these are the friend of the income investor.



Source: Congressional Budget Office

In order to compete for bond buyers, the Treasury will have to attract them with higher interest rates. Knowing the Treasury will have to be offering over $1 trillion per year in new debt for the next ten years, it is easy to see why we expect rates to head higher in the long run.

Strategy:

The good news is that there is no magic bullet that can cure the fiscal situation the government finds itself in. This means we can create some good long term strategies, knowing that what the Congressional Budget Office has projected is a very likely scenario. Here are several ways income investors can benefit from the current trend:

1 - Invest where dividends/income can rise over time. (This doesn't include short term investments such as CDs or bonds that mature and then the investor rolls into a higher rate.)

2 - Keep maturities short term. (Under 3 years) (This does not include stocks)

3 - Ladder bond investments. (1/3 - 1 yr; 1/3 - 2 yrs; 1/3 - 3 yrs)

4 - Do not reach for yield. Stay away from high yield bonds and stocks. They tend to perform poorly when rates are rising.

5 - Stay with the high quality ratings (AAA, AA)

Investments to Avoid:

We know certain asset classes do particularly poorly during rising inflation and interest rates. So, when putting together our Model Portfolio for Income, we eliminated certain asset classes due to their poor performance during rising interest rate environments. All of these investments may have attractive current yields, but the potential losses of principal are too great. A 6% current yield doesn't make up for a 20% principal loss.

Excluded:
Preferred Stocks -
No maturity, so they can decline as long as rates are rising.

Long term bonds -
Even thought hey have a maturity value, the price on the secondary market can fluctuate widely and why hold a long term low yielding investment while rates are rising?

Junk Bonds -
Low rated bonds bring an additional risk - default. As rates rise, the issuer can have trouble and actual default on the bond. This means the bondholder may get nothing. Zero.

Intermediate term bonds -
Like long term bonds, they can fluctuate widely as rates rise. Again, why hold onto a ten year bond as rates are rising on new bonds?

Financial Stocks -
Possibly the riskiest investments during a rising rate environment. They can be highly leveraged and get squeezed as rates rise. This could force dividend cuts or elimination.

Mortgage debt -
Long term by nature, mortgage debt can also fluctuate widely as rates rise.

REITs -
Many REITS are just mortgages on commercial real estate. Our research indicates that the commercial real estate area still has more trouble to go and defaults are likely.

Investment	Current YTM
Money Markets	0.02 - 0.04
T-Bills (90 day)	0.10 - 0.25
CDs (6mos)	0.50 - 1.00
CDs (1 yr)	1.00 - 1.25
Commercial Paper	0.10 - .99
Int Treasuries	3.50 - 3.75
LT Treasuries	4.40 - 4.85
Inv Grade Corp Bonds	2.00 - 5.00
Junk Bonds	7.00 - 10.00
Preferred Stock	5.00 - 7.00
Emerging Mkts Debt	4.00 - 6.00
Dow Jones Ind Ave	3.00 - 4.00
DJ Utilities Ave	3.50 - 4.50
TIPs	2.00 - 3.00

Yields are for demonstration purposes only. These yields are from March of 2010 and represent a range of recent yields. You may or may not get these yields. Prices and yields will vary.

Source: Yahoo!; BondTrader Pro; Format: CIS

Investments We Currently Utilize:

Our strategy is to merge our successful risk management strategy with the income needs of investors. Listed below are the types of investments we use. We may or may not use the specific investments in your portfolio. There are many factors for this including timing, value, yield and risk. This is an overview of the types of securities we believe have

Background:
To the right is a comparison of current yields of some investments. Income investors need to know what the range of current yields are and this sets the stage for a better understanding of the challenges they face.

No investment is without risk. The higher yields are theoretically compensation for the additional risk. **If an investor wants income with no risks, other than inflation and bank failure risk, then they should stick with bank CDs** and stop reading right here.

If you have read this far, I will assume you have rejected the prospects of depending on low yielding banks CDs.

At Cornerstone we have reviewed various income options and have evaluated the potential risks. We believe that with the right risk managements and asset allocation, an investor can enjoy higher yields while not exposing themselves to undue risks.

We are not eliminating risk. The income investor needs to be more focused on the cash flow than the principal, since the principal will fluctuate. If you do not want to see your principal fluctuate, then bank CDs are for you.

the best chance for success.

Income Stocks:
Bonds are normally the first stop for the income investor. But certain stocks fulfill the requirements of rising income and low interest rate sensitivity. Bonds can't do this.
(All yields quoted are estimates and are from Morningstar and Bond Trader Pro. They represent investments within the asset class referenced that fit into our requirements. There will be securities in each asset class with higher or lower yields.)

Utilities -
These are economically sensitive, and have some interest rate sensitivity. Historically, they have been used as sources of rising dividend income.
Current yields range from 2.00% - 5.50%

Drug Companies -
With the aging population and the globalization of healthcare and consumer goods, drug company earnings are more stable and dividends more reliable. This is another good source of rising income.
Current yields range from 2.00% - 6.50%

Consumer Goods -
Even with a slowing economy, people still need the basics and with growing consumerism in the emerging nations many companies are finding new markets in which to sell their goods. This stabilizes earnings and solidifies dividends. Consumer goods have been a good source of rising dividends.
Current yields range from 2.00% - 6.00%

Investments We Currently Utilize:

Natural Resource Companies/Oil Companies - Hard Assets are one of the big winners of the Urbanization that is sweeping the Globe. The emerging markets are consuming natural resources at rates much faster than the developed world. This has the potential to ignite inflation here while they drive prices higher. Although volatile, and have dividends that can fluctuate, these companies have the potential to outperform and raise dividends faster than the average stock.
Current yields range from 2.00% - 4.50%

Banks - What are banks doing on our list? None are domestic banks. As economies recover, they can be some of the first beneficiaries. Earnings can be volatile and so dividends may also vary. Potential for good long term income growth.
Current yields range from 2.00% - 4.50%

Emerging Market Stocks/Bonds - The fastest growing areas in the world are in the Emerging Markets. Lead by China, they are separating themselves from the developed economies by having little debt and higher growth rates. Volatility and long term growth are the main stories here. Earnings will be volatile, potentially leading to some good dividend increases. Focus is on needed growth for future income.
Current yields range from 0.00% - 5.00%

Aggressive Income - Royalty Trusts and MLPs can be good sources of high income. But they can also be depleting assets. They need to be traded and watched carefully. The yields are high for a reason. These are high risk.
Current yields range from 5.00% - 10.50%

Bonds:
The strategy on bonds is simple, ladder them out about 3 years and as the first year bonds come due, buy a 3 year bond. In this way, an investor is able to follow interest rates up as they rise. Current rates are very low, so they need to be used in combination with other asset classes for the overall portfolio to have a higher current yield.

- **Corporate Bonds**
Strategy: Ladder 1 - 3 years, highest quality only.
Ratings and maturity have a lot to do with pricing and yield. The coupon does not tell you how much you will get. The Yield to Maturity is what the investor receives in yield. Corporate bonds have an added risk of default. Looking for only the highest quality is important.

We look for bonds that are priced “wrong” for their ratings and maturity. For instance, the XYZ bond might have the same rating and maturity date as ABC bond, but is priced much lower, giving it a higher YTM. The questions is, what is wrong with it? Is it worth the risk? The yield to maturity alerts us to pricing that might be out of the ordinary. It could indicate a good buy or a problem bond. Just looking for the highest yield to maturity is not a good strategy.
Current yields to maturity range from .10% - 2.20%

Investments We Currently Utilize:

- Muni Bonds
Strategy: Ladder 1 - 3 years, avoid certain states.
Municipal bonds have a variety of types of bonds and risks. We primarily look for General Obligation bonds, due to their lower risk, but other bonds such as pre-refunded or certain revenue bonds could be appropriate for our purposes. Insured bonds may not be a safe haven because of the questionable finances of the insurers.

Our strategy is the same as with Corporates, to be patient and look for mis-priced bonds. Muni bonds also have the risk of default, so care is needed to not just go for the highest YTM.
Current yields to maturity range from .10% - 1.75%

Treasuries/TIPs
Strategy: Ladder 1 - 3 years.
Because of the efficiency and liquidity of the Treasury market, there no chance of finding mis-priced bonds. Because of their low current yields, Treasuries are used for their safety more than their yield. But a laddered portfolio will allow us to follow rates as they go higher, and eventually, we believe yields on Treasuries will be attractive.

TIPs (Treasury Inflation Protection Securities) are the preferred type of Treasury because they offer a "bonus" on the yield based on the inflation rate. Since inflation is one of the key enemies of bonds, getting based on the inflation rate dampens some of the risk.
Current yields to maturity range from .10% - 2.00%

Junk Bonds - Muni/Corp
Strategy: Small amounts only.
Low rated bonds can have very attractive yields. But they are low rated for a reason, they have plenty of risk of default. We are not opposed to using low rated bonds, but they have to be done in very small amounts as to not increase the risk of the portfolio.

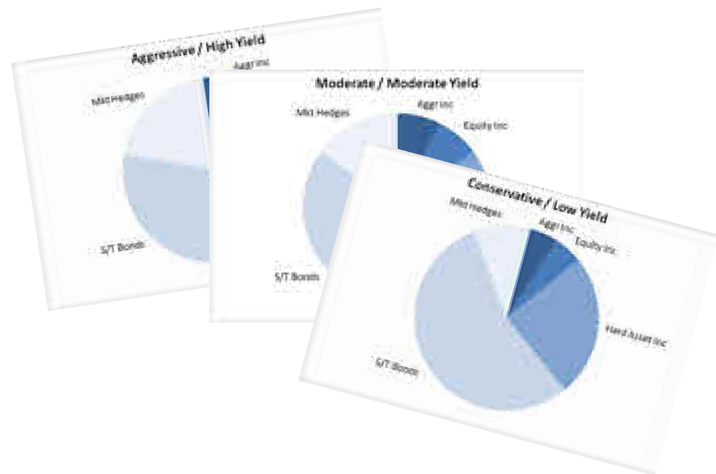
Mutual Funds: (Share classes will impact yield*)
Because of the high turnover within the portfolio, short term bonds are well suited for the mutual fund structure. Advantages they offer are professional management and diversification. The yields of the funds we utilize range from a low of 1.50% to a high of 3.50% according to Morningstar. As always, the higher the yield, the more risk the fund is taking.

Duration and credit quality of the underlying portfolio may impact the volatility of mutual funds. Generally lower yielding funds may have much lower volatility. So while some may have higher yields, they come with higher risks.

ETFs - This is another efficient way to invest in short term bonds. They are easily tracked and highly liquid. The varieties of ETFs today allow us to focus on certain sectors we prefer.

Asset Allocation

We believe asset allocation can make or break the total return performance of a portfolio. It would be a mistake to just look for the highest yielding investments and try to build a portfolio out of those. The higher the yield, the riskier the issue. High yielders can find a home in a well diversified portfolio, if they are a small percentage and the investor understands the risks involved. We can customize and income portfolio for the client's needs. Generally, they would be classified as Aggressive, Moderate and Conservative based on risk tolerance of the investor and income.



We will also include some assets classes not mentioned above. This is because they are not income oriented but are part of our standard Model Portfolio. Precious Metals can be an inflation fighter, offsetting the impact rising inflation may have on the portfolio. Hedge positions (Inverse stock and bond ETFs and funds) can give the investor an additional layer of protections against market declines. Inverse funds are designed to go up as markets go down.

Conclusion

With discipline and patience, we believe that an income investor can not just survive the current low yielding environment, but take advantage of it. Eventually, yields will be much higher than today, but until then, it is important that income investors not reach for yield, especially in areas that could be devastated by rising inflation and interest rates.

By combining our Model Portfolio's strategy with the needs of income investors, we believe that this method can keep investors from taking undue risks while still supplying them with the income they need.

* There are generally 4 mutual fund share classes. The higher the internal fees, the lower the yield will be to the investor on the same fund with different share classes. Generally, A shares and institutional (no-load) shares have the lowest internal fees. B and C shares tend to have the highest internal fees.

Disclosures

Accuracy

Information was obtained from sources believed reliable but is not guaranteed. All information provided "as is" for informational purposes only, not intended for trading purposes or advice.

Strategy

Diversification does not ensure a profit or guarantee against a loss. There is no assurance that any investment strategy will be successful. Investing involves risk and you may incur a profit or a loss.

Money Manager

Cornerstone Investment Services, LLC is a registered investment adviser. The company is privately owned. The company maintains a complete list and description of composites, which is available upon request. The Cornerstone Model Portfolio (CMP) is an integral part of our investment management process, although no client owns the CMP, all client portfolios follow it and are similar in compositions and asset allocation. CIS allocates each client's portfolio differently, Conservative, Moderate or Aggressive.

Performance

The performance data featured represents past performance, which is no guarantee of future results. Investment return and principal value of an investment will fluctuate; therefore, you may have a gain or a loss when you sell your shares. Current performance may be higher or lower than the performance data quoted.

All discretionary accounts follow the CMP, but none are identical to it. Cornerstone's money management process may makes

changes to the CMP and then applies those changes to client portfolios as appropriate. There are times when the client portfolio may be changed in advance of the CMP. Client portfolio performance will differ from the CMP due to various factors including, but not limited to time, asset allocation, income distributions and risk tolerance of the investor. Client portfolios will also differ from each other since no two portfolios are identical.

The performance information is supplied for reference. Past performance is no guarantee of future results. Results will vary

among accounts. The U.S. dollar is the currency used to express performance. All material is compiled from sources believed to be reliable, but accuracy cannot be guaranteed.

Mutual funds are sold by prospectus only. Please carefully consider the fund's investment objectives, risks, charges and expenses applicable to a continued investment in the fund before investing. For this and other information, call or write for a free prospectus on applicable funds, or view them online. Read the prospectus carefully before you invest or send money.

Bonds contain interest rate risk (as interest rates rise, bond prices usually fall); the risk of issuer default; and inflation risk. The municipal market is volatile and can be significantly affected by adverse tax, legislative, or political changes and the financial condition of the issuers of municipal securities. Interest rates increases can cause the price of a debt security to decrease. A portion of dividends you may receive may be subject to federal, state or local income tax or may be subject to the federal alternative minimum tax. A portion of a mutual fund's income may be subject to state taxes, local taxes, and the federal alternative minimum tax.

Please carefully consider the ETF's investment objectives, risks, charges, and expenses before investing. Read all prospectuses carefully before investing.

For other information please contact Cornerstone Investment Services, LLC at (401) 453-5550. This report is not to be considered an offer to buy or sell any financial instrument. As with all investments, there are associated inherent risks.

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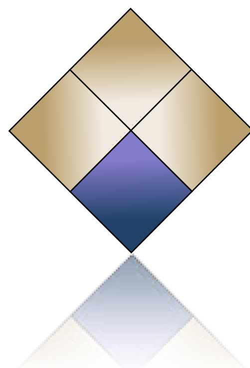

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