Investor Quarterly

ROCKINGSTONE ADVISORS LLC

CONTENTS

COVER
3Q12 REVIEW
A summary of third quarter performance

2.1
3Q12 IN DETAIL
A detailed look at 3Q12 performance across and within multiple assets

3.1
4Q12 OUTLOOK
Factors that we believe will drive 4Q12 performance

4.1
ASSET PRICE FORECAST
Our 5-year forecast by asset class

5.1
FOCUS: REAL RATES
Negative real interest rates have broad-based implications for investors and borrowers

7.1
CLIENT SOLUTIONS
A less theoretical approach to the practical problems that face our clients

Rockingstone Advisors LLC is a boutique financial advisory firm providing asset management and corporate advisory services

Central bank liquidity actions fuel third quarter rally

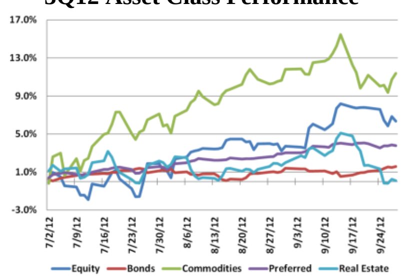
3Q12 Review

Financial assets experienced a broad-based rally in the third quarter, fueled mainly by central bank actions to add liquidity and stem the European debt crisis.

All major asset classes rallied, with the greatest gains in "risk" assets, including commodities, followed by equities, preferreds, fixed income and real estate.

The catalyst for the rally came on July 26th, when European Central Bank (ECB) president Mario Draghi said, "The ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

3Q12 Asset Class Performance[1]



Source: NYSE Arca

Equity markets rallied as sovereign rates on Italian and Spanish debt plummeted. The initial move was confirmed as Mr. Draghi's plan to purchase sovereign bonds was supported by Germany, subject to certain procedures.

While the ECB actions alone would have been sufficient to spark the rally, it was sustained by central bank actions in the U.S. and Japan.

In the U.S., Federal Reserve chairman Ben Bernanke announced a plan to purchase $40 billion monthly of mortgage-backed securities, in addition to extending Operating Twist and continuing the Fed's low interest rate policy through mid-2015.

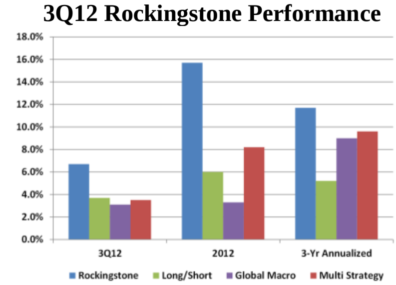
In Japan, the Bank of Japan (BoJ) expanded its asset purchase and loan program by 10 trillion yen.

Rockingstone's 3Q12 Performance[2]

Benefiting from Risk

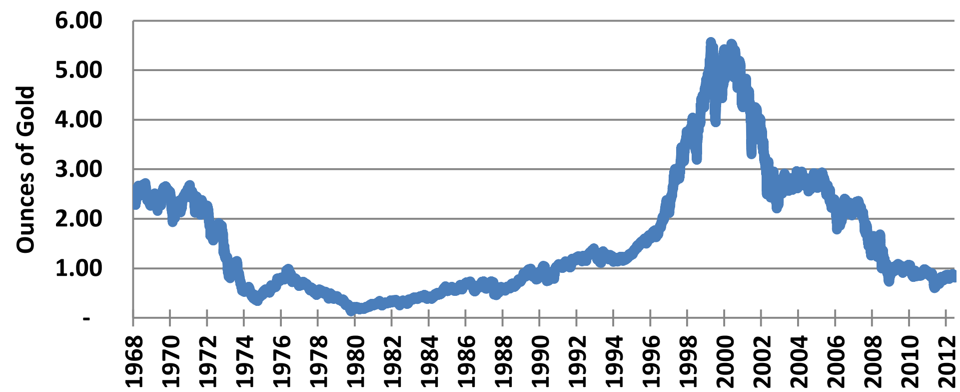
Rockingstone Advisors had a solid quarter, posting a gain of 6.7%, as we benefitted from increased equity and commodity exposure. Our YTD return is +15.7% and our 3-year annualized return is +11.7%. We maintained our underweight in fixed income, but did add to high yield and preferred stock positions in July and August.

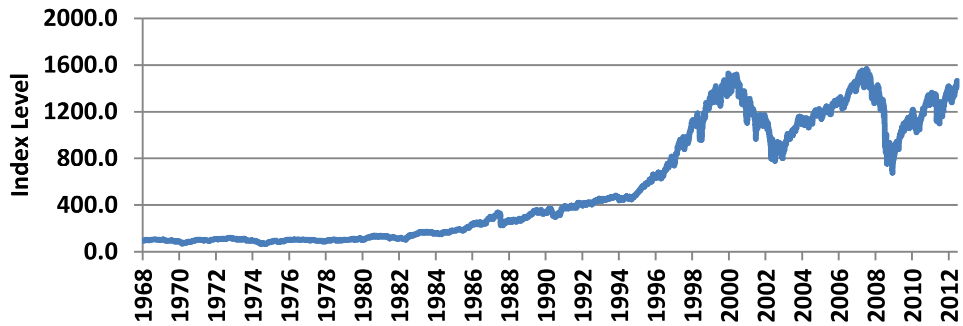
3Q12 Rockingstone Performance



Source: Morningstar, DJ Credit Suisse

Please see page 8 for important regulatory disclosures.





S&P 500[3]

REAL (TOP CHART) AND NOMINAL (BOTTOM CHART)

As the two charts on the left indicate, the nearly doubling of the S&P 500 off of its 2009 lows (bottom chart) is an illusion: in real dollars, the market is actually not far off of its secular bear market lows of 1980 (top chart).

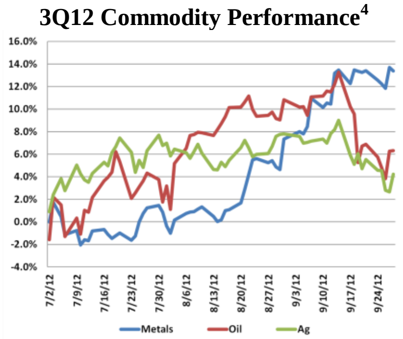
Source: Federal Reserve/FRED

2.1: 3Q12 Detailed Performance

Commodities

All asset classes recorded gains in the third quarter, but commodities recorded the strongest gains of all, rising more than 11% in the quarter.

3Q12 Commodity Performance[4]



Source: NYSE Arca

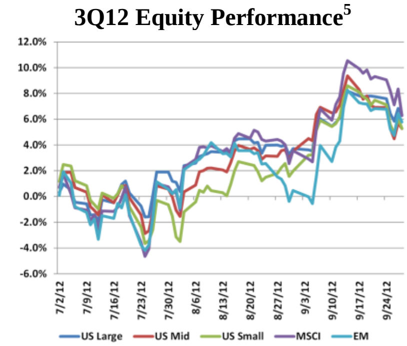
Not surprisingly given the catalyst behind the rally, precious metals led the upsurge in commodities, gaining almost 14%. Oil slightly outperformed Agriculture, but mainly due to profit taking in the agriculture sector following a massive run in prices due to the drought in the Midwest and plains states. Oil rose just over 6% and Agriculture was up about 4%.

The commodity complex peaked in mid-September, with Oil and Agriculture giving up some gains on weaker macro-economic data; however, precious metals continued to rise through the end of the quarter.

Equities

Equity prices rose more than 6% in the quarter. Foreign developed and U.S. large cap marginally outperformed U.S. small and mid-cap and emerging markets, as investors assumed that Mr. Draghi's actions, and the concomitant rise in the euro against the dollar, would most likely benefit European companies and U.S. multinationals. US large and foreign developed each rose more than 6%. Emerging markets stocks rose 5.8% in the quarter, while U.S. small and mid-cap stocks rose 5.3%.

3Q12 Equity Performance[5]



Source: NYSE Arca

Stocks were mainly flat to up slightly for the first month of the quarter, reacting to mixed second quarter earnings results that were characterized by slowing fundamentals and negative currency effects, as the dollar rallied materially against the euro from April to June 2012, impairing the results of U.S. multi-nationals.

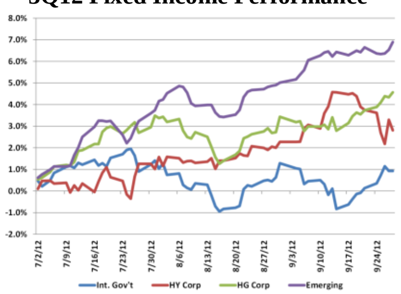
Fixed Income

Fixed income securities rose 1.6% in the third quarter, underperforming commodities, equities and preferreds, but outperforming real estate.

Within fixed income, "risk" assets generally outperformed "safe" assets, as emerging market bonds outperformed both high yield and high grade corporates and not surprisingly, intermediate government bonds.

Emerging markets bonds rose 6.9%, while high grade corporates rose 4.6%, surpassing the performance of high yield corporates, which rose 2.8%. High yield corporates had outperformed high grade though mid-September, when macroeconomic issues re-surfaced, leading to some profit taking in high yield bonds.

3Q12 Fixed Income Performance[6]



Source: NYSE Arca

Treasuries recorded gains of just 0.9%, and frankly would have ended the quarter with a negative return had it not been for the end-of-quarter "risk-off" rally that put marginal pressure on lower quality bonds.

3.1: Our 4Q12 Outlook
Reducing Risk

Following the strong third quarter and year-to-date performance for investable assets, we began reducing our exposure at the end of the quarter, and initiating short positions in our long-short accounts.

This is due to the expectation that while financial markets may find some degree of support from accommodative monetary policy, valuations are ultimately based on corporate profits, and we are increasingly concerned about the outlook for third quarter profits to be released in mid-October.

We are troubled by the pre-announcements from economic bellwethers Fedex (FDX), 3M (MMM), Norfolk Southern (NFS), and Eagle Bulk Shipping (EGLE), which we believe may be a harbinger of more bad news to come during earnings season.

In fact, by the close of the third quarter, according *to Thompson Reuters*, 112 of the 500 companies in the S&P 500 had pre-announced, of which 78 expected to miss forecasts while only 34 expected to beat forecasts, the worst performance ratio since 3Q01.

We believe the bulk of the disappointment will be in large, global firms with exposure to China and Europe, especially those with a lot of exposure to manufacturing and capital goods. We believe consumer-oriented stocks (both discretionary and staples) may outperform.

In addition, there continues to be a great deal of uncertainty surrounding the elections as well as the "fiscal cliff."

With respect to the elections, we believe it is a very close race, closer than odds on both *Intrade* and *The New York Times* indicate (62% and 63%, respectively for an Obama victory).

Negotiations surrounding the fiscal cliff may weigh on the market, especially the uncertainty surrounding tax rates on dividends as well as on capital gains rates. In addition, we expect selling pressure on stocks with outsized gains as investors seek to lock-in favorable capital gains tax rates and re-set their basis for the prospect of potentially higher taxes.

That said, there are two factors that would make us increase our risk exposure: (i) failure of stocks to respond negatively to earnings disappointments, or (ii) indicators that the macroeconomic deceleration is nearing an end with clear prospects of the economy re-accelerating on improving demand from China and stabilization in Europe.

Under the first scenario, we assume that the market is presently discounting some earnings disappointment, but we suspect that investors may be surprised by both the degree of disappointment and the negative commentary regarding 4Q12 guidance. If this turns out not to be the case-- and in fact stocks rally on the "removal of an overhang," we would obviously reevaluate our position.

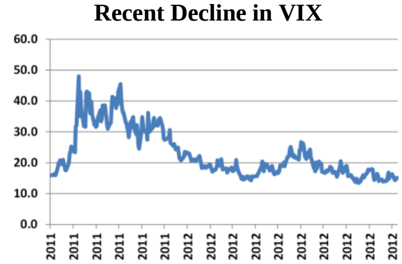
Under the second scenario, there is a case to be made that sentiment in Europe has improved since this summer, and that Chinese authorities will undertake renewed efforts to counter the economic slowdown following the leadership change in Beijing next month.

These factors, coupled with greater visibility in the U.S., might translate to increased investment activity, which would mark a trough in earnings growth rates in either the third or fourth quarter.

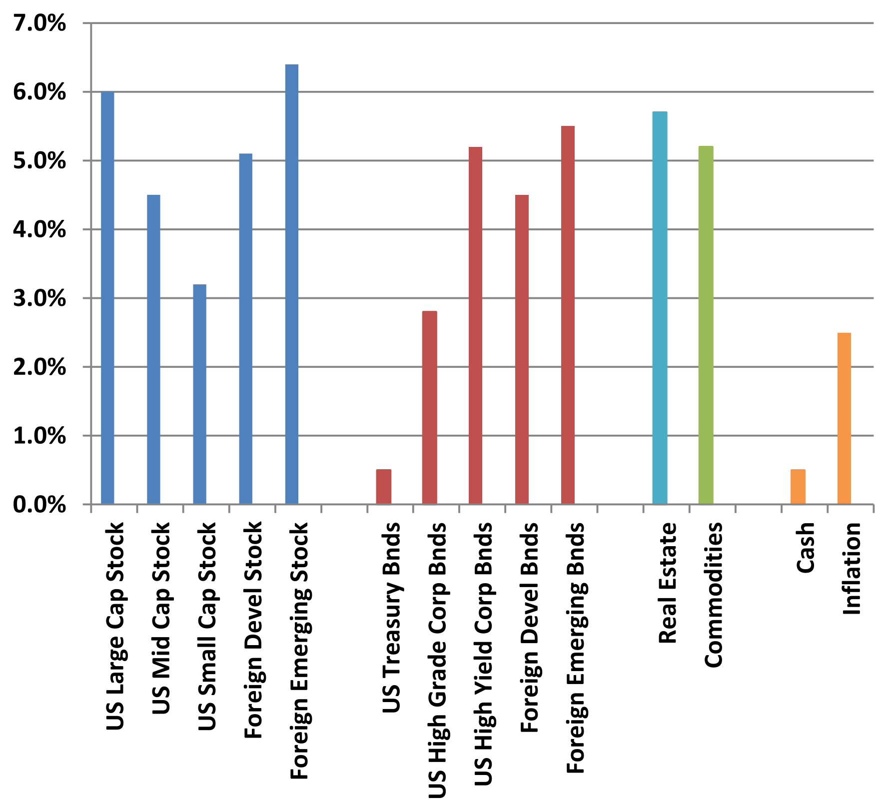
Effectively we have two potential outcomes: either 3Q12 earning are an anomaly, and over the next few months we resume the corporate profit growth witnessed since the recovery began in 2009, or 3Q12 earnings are really the first warning sign of an impending multi-year global slowdown.

Currently, we do not believe there is adequate information to draw a clear investment conclusion. For this reason, during uncertain periods like these, it is usually best to lock-in gains, reduce risk, raise cash and be positioned to take advantage of any opportunities that present themselves as the data become clearer.

Recent Decline in VIX



Source: Federal Reserve/FRED



5-YR FORECAST[7]

BY ASSET CLASS

We update our asset class forecast quarterly, based on recent performance, updated earnings estimates and relative value changes.

Presently, we believe U.S. large cap stocks, emerging stocks, real estate and commodities offer the best five-year return potential.

We note that we expect inflation to trend above the Fed's 2% target, dampening real returns on most assets.

Source: Rockingstone Advisors LLC

4.1: Five-Year Asset Value Forecast

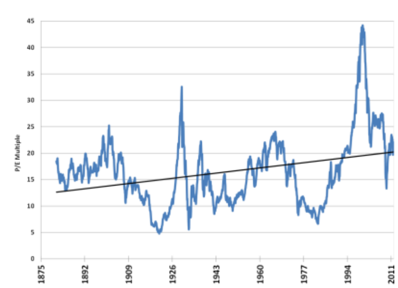
Equities Continue to Offer the Best Value

According to our five-year asset value forecast, we continue to believe that US large cap and emerging market equities may continue to offer the best total return potential, followed by real estate, commodities and emerging markets bonds. We see U.S. high grade corporate bonds offering middling returns, and U.S. treasuries offering negative returns when adjusted for inflation.

In general, though, we do not expect stellar real returns from any financial asset over the next five years, as a combination of low yields driven by financial repression, coupled with fiscal austerity in the U.S. and Europe may continue to put downward pressure on returns from financial assets.

The key takeaway is the word "real." An accommodative monetary policy typically inflates the nominal value of leveragable assets (real estate, stocks, bonds, commodities) but when priced in real assets returns evaporate.

Shiller CaP/E[8]



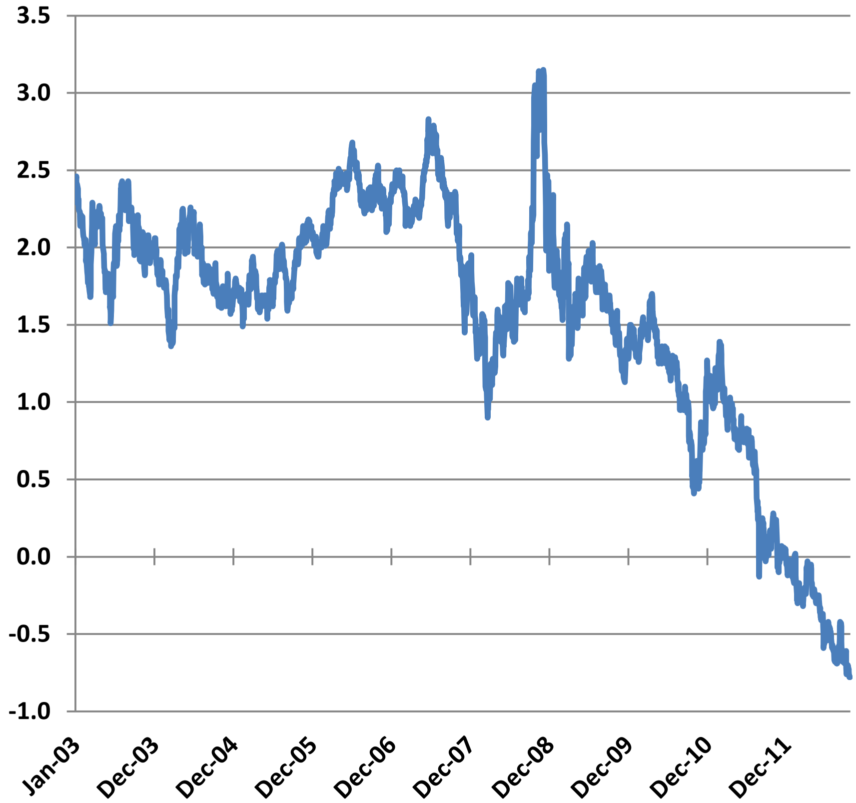
Source: Robert J. Shiller, Yale University

Our large cap equity forecast is derived using two methods: (i) the cyclically-adjusted P/E multiple (the Shiller P/E) times our S&P 500 earnings, and (ii) the current (unadjusted) P/E multiple. We then estimate mid-cap and small-cap returns based on the relative value of each index to the S&P 500.

Presently, the S&P 500 trades at (an unadjusted) forward P/E of 13x 2013 earnings, a P/E to Growth (PEG) ratio of 1.2x and a dividend yield of 1.9%. Mid cap stocks trade at about 15x 2013 earnings, a PEG of 1.1x and a dividend yield of 1.5%. Small cap stocks have a P/E of 15x earnings, a PEG ratio of 1.1x and a dividend yield of 1.3%.

Hence, we believe large caps continue to offer the best return potential over the next five years, particularly when returns on equity (ROE) are factored into their relative valuations: large caps recorded a trailing twelve month (TTM) ROE of 34.3%, while mid caps were 14.8% and small caps just 10.8%, according to *Standard & Poor's*.

We continue to be underweight fixed income, with the exception of high yield and emerging market bonds. We see limited returns and substantial risk over the next five years in high grade and treasuries. In an environment of negative real rates (see following section), we believe strongly that it is better to be a



10 YEAR TIPS[9]

CONSTANT MATURITY

Negative real rates are relatively rare, and usually caused by a rapid rise in the price level (as in the 1970s) rather than a massive decline in rates, as we have today.

Negative rates have several implications for investors, which we detail in our *Focus Section* this quarter.

In sum, you want to be a borrower, not a lender in the current environment, as borrowers repay less than their original notes in real terms.

Source: Federal Reserve/FRED

borrower than a lender.

To arrive at expected commodity returns we start with our expectation for inflation and then adjust for anticipated changes in supply and demand, as well as changes in the dollar as most commodities are priced in dollars.

Finally, we believe yield-driven assets like real estate and preferreds will perform well in a sustained, low-interest environment. We expect inflation to trend above the Fed's target rate of 2%.

5.1: Negative Real Interest Rates

Issues & Implications

Currently, the U.S 10-year (constant maturity) treasury yield is 1.7%, but adjusted for inflation (or using TIPs as a proxy), the yield is *-0.8%*, up-ending modern portfolio theory and creating an extremely challenging investment environment, for the following reasons:

- US treasuries are the "risk-free" rate from which all other assets are priced;
- Real rates have turned negative due to financial repression by the Fed, rather than the natural form of price discovery that is the outcome of free market participants;
- Interest rates drive currency values; negative real rates puts pressure on the dollar and dollar-priced commodities; and
- Fixed income has lower volatility than equities and is obviously senior to equity holders in a liquidation, but its traditional "safe" role in a portfolio is in jeopardy given negative real rates.

We examine each of the issues associated with negative real rates, and the implications for investors.

The "risk-free" rate

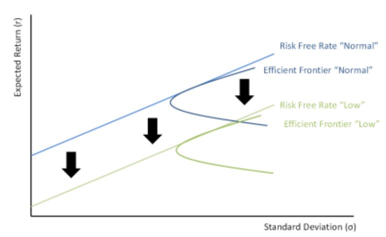
One of the anchors of modern portfolio theory, and the Capital Asset Pricing Model (CAPM), is the risk-free rate, generally considered to be the yield on a 10-year U.S. Treasury bond.

At the risk of oversimplifying, returns on all investable assets should depend on the amount of risk of that asset (its volatility measured by standard deviation) relative to the risk-free asset. While some may argue that a historical range for the 10-year should be used, the reality is that investors face investment decisions today, with today's risk-free rate and present borrowing costs governing their current asset allocation or their capital spending assumptions.

The implication of exceptionally low risk-free rates means that the expected returns of other investable assets must also be lower given the same degree of risk.

Argued another way, investors must increase their risk to generate identical returns, essentially driving investors out of safe assets: treasury buyers purchase high grade corporates, high grade corporates are replaced by high yield, high yield is replaced by dividend equities and so on, as the following chart depicts.

Efficient Frontier



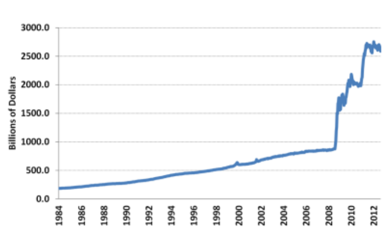
Source: Markowitz, Treynor, Sharpe, Lintner, Mossin

Financial repression

The Fed, through its setting of short-term interest rates, open-market purchases of bond and mortgage securities and reserve requirement ratios, exerts enormous influence on interest rates. While it's difficult to figure out where rates would be without the Fed action, it's highly unlikely that rates would be lower than they are today without Fed action; otherwise Chairman Bernanke and the FOMC would not be adding substantially to the Fed's balance sheet.

So the reality of the Fed's action is effectively a price control on interest rates. Set a minimum price above the market and there is a surplus, set a maximum price below the market and there is a shortage, to paraphrase Milton Friedman.

US Monetary Base ($ Bil)



Source: St. Louis Federal Reserve/FRED

So if we assume that the Fed is setting a price for money that is below where the market would otherwise clear, there should be a shortage of willing lenders at that rate. Yet the Fed, as lender of last resort, and as an unsterilized purchaser of treasury bonds, can effectively supply all the funds demanded at artificially low rates.

The obvious implication is that the Fed risks doing effectively what Friedman warned against: misallocating resources. Free money will find its way not only into goods and services, but into any asset which benefits from leverage. Inflation of financial assets typically occurs, until some exogenous event pops the bubble at the worst possible moment, and the asset bubble deflates as rapidly as it inflated.

So the implication of financial repression is that investors must be sufficiently nimble to participate in the asset bubble rally (or see their purchasing power fall as rapidly as the bubble inflates), and then be prepared to jump off the bandwagon before the asset bubble bursts. This strategy argues for managing liquidity more than anything: nimbleness cannot be achieved with large fixed assets that cannot be quickly sold at the press of a button.

The U.S. dollar

One of the fallouts of a negative interest rate policy is pressure on the U.S. dollar. A currency derives its value, in our view, in a way somewhat similar to a stock: there is a quantitative component (the yield), and a qualitative component (the strength of its brand, quality of management, track record of success).

Negative real yields obviously directly affect the yield component of the dollar's valuation, but they also affect the qualitative elements-- debasing the currency is sort of the easy way out, especially when that currency happens to be the world's reserve currency. It is akin to a management team making its quarter through accounting gimmicks.

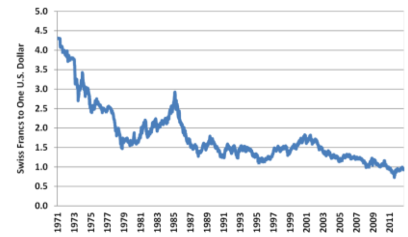
For investors, there are several implications of a lower dollar.

First, all imported goods increase in price, so the U.S. effectively imports inflation.

Second, all global goods priced in dollars also rise in price: oil, agriculture, and industrial and precious metals, to name a few.

Third, U.S. exports surge as they become more price competitive.

US Dollar/Swiss Franc



Source: Federal Reserve/FRED

Unfortunately, the combination of rising food and energy prices, and reduced competitiveness abroad can create economic stress, trade tensions and social dislocation, including revolutions, especially in those countries with unstable governments, uncompetitive economies and few natural resources.

The conundrum for investors is that they must diversify their assets away from U.S. dollars to maintain their spending power, but the diversification cannot be into regions whose stability is threatened by this very devaluation.

Moreover, since a large portion of our outstanding debt is financed abroad, a lower dollar raises the risk that foreign buyers of treasuries will stop doing so, leading to a rapid and exceptionally dangerous rise in rates.

When safe assets aren't

Without a doubt, the most worrisome aspect of negative rates is that treasuries, given their "risk-free" status, assume the role of the conservative allocation in most investor portfolios.

When the most conservative part of a portfolio is actually the riskiest due to its valuation, then the implications are far reaching, as evidenced by the European debt crisis. The sovereign crisis in Europe is fueled in large part when

CLIENT SOLUTIONS

MORNINGSTAR DASHBOARD

An online dashboard offering daily updates on all asset and liability accounts tracked by Rockingstone Advisors, but not necessarily managed by us.

Additional tabs allow for drop-down menus examining individual account holdings and secure documents and reports.

Please note: Data are fictitious and only for illustration purposes.

Source: Morningstar and Rockingstone Advisors

allegedly risk-free assets turn highly risky, made worse by inadequately capitalized banks, excessive public sector spending and slow population growth.

That valuation matters significantly for safety is still widely debated, especially in a world where risk is too frequently measured principally by standard deviation (CAPM, VaR). But both Jeremy Grantham and Robert Shiller have written extensively about the risks of buying inflated assets: Grantham has built a very successful asset management firm around avoiding asset bubbles, and Shiller showed in 1996[10] that P/E ratios can explain nearly half the variance in stock price changes.

If we start with the "Fed Model" that compares the earnings yield of the S&P 500 (the inverse of its P/E) against the yield of the 10-year Treasury, using the Shiller P/E of 20x cyclically adjusted earnings, we arrive at an earnings yield (the inverse of the P/E) of 5%, which according to the Fed model should be the yield of the 10-year Treasury. It's not. So at a current yield of 1.7%, either bonds are vastly overvalued, stocks are vastly undervalued, or the Fed model is wrong.

But the Fed model is not an outlier--by nearly every measure (especially the level of mutual fund money flows out of equity and into fixed income), bonds look exceptionally expensive, and expensive assets are very risky.

Client Solutions

Tracking multiple assets in multiple places

We realize that the principal purpose of a quarterly newsletter is to help clients (and future clients) understand how we are performing, how we see the world and how we are positioning their portfolios to benefit from the outcome we expect.

But sometimes this approach can lead to an overly-theoretical research effort, when the problem that clients frequently face are far more practical in nature—like simply how to track multiple investments in one place, how to ensure that interest on a private mortgage or loan is calculated properly, and even whether to take out a mortgage even though there are ample assets to purchase a home with cash.

We will try to use this section each quarter to address one of the practical issues our clients face every day and how we deal with them.

Since most of our clients have multiple assets and investments at a variety of brokerages and advisors, one favorable aspect that we wanted to highlight this quarter was the *Morningstar Dashboard*.

We switched from *Schwab Technology Solutions* to *Morningstar* to run all of our portfolio analytics. We were attracted to the fact that Morningstar understood that if we owned a fixed income ETF, we were long a bond and not a stock (this sounds basic, but shockingly it's not, especially when dealing with commodity or short ETFs and ETNs).

What Morningstar also allows is for us to add individual holdings—from a hedge fund to a real estate partnership, and track performance and income from each of these accounts.

In addition, Morningstar offers an online dashboard (see figure on page 7) that shows the daily asset value of all of your investment accounts, as well as geographic and asset class exposure.

Of course the data must be input by us or communicated to us as we rarely have direct data links to each of these accounts, but it is an easy way that investors can see all of their assets in one place.

More importantly, though, by aggregating accounts the dashboard allows our clients to see how all of their assets are working together, and to determine if they have excessive exposure in a way that would not be clear by a segregated account view.

End Notes

Please Read Carefully

[1] Asset Class Performance chart depicts Equity (SPY ETF), Bonds (BND ETF), Commodities (DBC ETF), Preferred (PFF ETF) and Real Estate (VNQ ETF) price changes plus dividends and income during the period.

[2] Rockingstone Advisors Performance chart depicts the aggregate average of all accounts invested with a similar objective and risk tolerance; individual account performance may materially differ according to strategy and portfolio composition. Returns calculated using time-weighted method (TWM) and are weighted by portfolio assets. Returns are calculated by *Morningstar* based on information received from our custodian, *Charles Schwab & Co*. Three-year annualized return is based on return since inception, June 1, 2009. Benchmark selections reflect strategies that in our opinion are closest to the way that aggregate portfolios are managed, but may differ from any individual portfolio's strategy. Past performance is not indicative of future performance. Mean reversion is a powerful force. All figures are net of fees and expenses. Rockingstone's performance must be assessed in light of not just how the benchmarks performed, but also how the broader indices performed as depicted in the accompanying charts of asset class performance.

[3] S&P 500 charts are courtesy of the St. Louis Federal Reserve FRED database. S&P 500 reflects total return, gold prices are based on London close of gold priced in USD.

[4] Commodity Price Performance chart depicts Metals (DBP ETF), Oil (DBO ETF) and Agriculture (DBA ETF).

[5] Equity Price Performance chart depicts US Large (SPY ETF), US Mid (MDY ETF), US Small (IWM ETF), MSCI (EFA ETF) and Emerging Markets (VWO ETF) total return, including dividends.

[6] Fixed Income Price Performance chart depicts Intermediate Government (IEF ETF), High Yield Corporates (JNK ETF), High Grade Corporate (LQD ETF) and Emerging Markets (EMB ETF); all figures include price changes and interest earned over the period.

[7] Our 5-year forecast is updated quarterly and reflects our best judgment on future performance based on current valuations and our outlook for earnings and macroeconomic conditions. We caution that predicting outcomes is inherently risky and subject to change.

[8] Shiller P/E (or cyclically-adjusted P/E) is the price of the S&P 500 divided by the average inflation-adjusted earnings from the prior 10 years. The Shiller P/E adjusts for the cyclicality of earnings (and corporate profit margins) during recessions and expansions. It is the intellectual property of Robert J. Shiller of Yale University.

[9] 10-year constant-maturity Treasury inflation-protected securities are courtesy of the St. Louis Federal Reserve FRED database.

[10] Shiller's 1996 paper, *Price-Earnings Ratios as Forecaster of Returns: The Stock Market Outlook in 1996* is available through Yale University's web site. Jeremy Grantham's work is also available on the web, at gmo.com.

IMPORTANT DISCLOSURES

Quarterly data priced as of September 28, 2012; all other prices and yields are as of October 16, 2012.

Please contact us if you have any questions, comments or concerns.

We are happy to provide the raw data for any of the charts or tables in this newsletter. We thank you for your interest.

Rockingstone Advisors LLC
500 Mamaroneck Ave.
Suite 320
Harrison, NY 10528
914-481-5050

brandt@rockingstoneadvisors.com

www.rockingstoneadvisors.com