

2011 First Quarter Market Review

Executive Summary

- The first quarter of 2011 produced strong returns for most asset markets, although in a somewhat less uniform fashion than prior quarters. U.S. stocks and commodities enjoyed solid gains based on improving economics and buoyant liquidity, but international markets were mixed. By the end of the quarter markets had settled back into rally mode as nuclear fears were subsiding and investors refocused on the strong economic and earnings backdrop.
- One of the major concerns that cropped up during the quarter was the rapid rise in energy prices around the globe due to escalating tensions in the Middle East and Africa (MENA) region. During the quarter oil climbed over \$100/barrel and gasoline prices surged over \$3.50/gallon. For the moment prices have increased, and rates of change are beginning to approach levels that have traditionally triggered problems in financial markets. But in our estimation they haven't quite reached a tipping point for the economy just yet.
- Pinnacle Advisory Group managed accounts opened 2011 on an upbeat note as the ongoing bull market in risk assets carried even higher in the first quarter. All portfolios achieved positive first quarter results, and are well above year ago levels.
- As the second quarter begins the U.S. economy appears to be gaining steam as a wide array of economic data is steadily improving, there is still plenty of liquidity, and there has been a gradual but notable improvement in the U.S. labor market. Inflation worries have surfaced recently, but there appears to be sufficient slack in the economy to counterbalance this inflationary impulse.
- Our base case continues to be that stocks will ultimately push to new cycle highs on the back of an improving U.S. economy, extreme liquidity in the system, and firm technical underpinnings. Of course, there are plenty of risks that remain that could bring about the demise of the bull market, ranging from shorter-term concerns like oil prices and interest rates to longer-term problems like deficits and debt.
- Our current forecast gives the bull market the benefit of the doubt, but in no way implies that this is the time to be swinging for the fences in our portfolio allocations. We believe that benchmark levels of risk are appropriate given the number of asymmetric risks that exist, the presence of significant structural economic headwinds, and an acknowledgement that the most explosive gains of this cycle have likely passed.

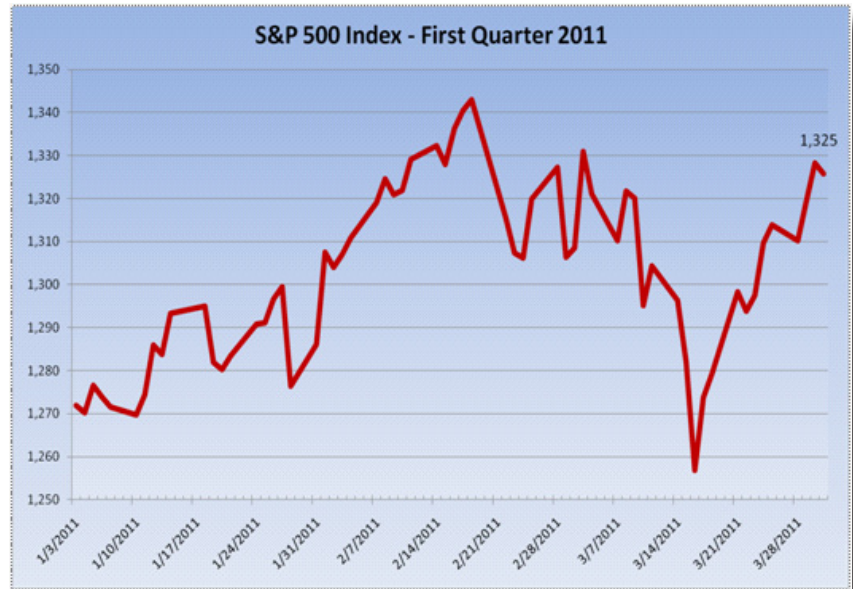
Written by:

Rick Vollaro, CPA
Chief Investment Strategist
Partner

Carl Noble, CFA
Senior Analyst

Fourth Quarter Review

The first quarter of 2011 produced strong returns for most asset markets, although in a somewhat less uniform fashion than prior quarters. U.S. stocks and commodities enjoyed solid gains based on improving economics and buoyant liquidity, but international markets were mixed due to tightening monetary policy, uprisings in the Middle East, continuing debt problems in Europe, and the tragic disaster in Japan. The quarter witnessed a brief return of volatility during February and March as an overdue shakeout finally materialized. Despite intense fear that developed in the wake of the worst nuclear disaster since Chernobyl, the -6.5% decline in the S&P 500 Index evaporated as fast as it arrived. By the end of the quarter markets had settled back into rally mode as nuclear fears were subsiding and investors refocused on the strong economic and earnings backdrop.



Index	First Quarter Return
S&P 500 Index (w/ dividends)	+5.92%
Russell 2000 Index (small cap stocks)	+7.94%
MSCI EAFE Index (international stocks)	+3.50%
Dow Jones/UBS Commodity Index	+4.45%
Barclays Capital Aggregate Bond Index	+0.42%
3-month T-bills	+0.03%

One of the major concerns that cropped up during the quarter was the rapid rise in energy prices around the globe due to escalating tensions in the Middle East and Africa (MENA) region. Oil and gasoline have been in an uptrend since bottoming in early 2009, and much of the rise in prices has been viewed as a healthy byproduct of the global economic recovery. However, the uprisings across the MENA region not only removed a small amount of supply from the market, but also produced a geopolitical risk premium into oil markets around the globe. The sudden destabilization in a major oil producing region was largely to blame for oil climbing over \$100/barrel and gasoline surging over \$3.50/gallon. As energy prices spiked investment analysts debated what the impact would be on the global economy. Various studies have projected every \$10/barrel rise in oil could subtract anywhere between 0.1% and 0.5% from GDP growth. Other reports estimate that every \$1/gallon increase in gasoline reduces discretionary income by as much as \$120 billion. While the exact amounts involved in this type of analysis is rarely uniform and the methods of calculation are debatable, the overall message is that the risk of an energy shock disrupting the cyclical bull market is clearly growing.

Our current thinking regarding oil and gas is that while price levels certainly matter, the speed of price appreciation may be more important to monitor. If prices rise gradually over a period of time as a result of the global economy firing on all cylinders, then financial markets may be willing to accept oil prices

quite a bit higher than they are today. However, today's concern is one of a very quick rise due to a supply side shock, which is a much more worrisome scenario. The premium currently being baked into oil markets appears to be less about actual supply problems, and more about the likelihood for continuing unrest across the Middle East. The wildcard in all of this is Saudi Arabia and the potential for a major global supply disruption if the popular revolts spread there. Accurately predicting the outcome of these types of events is inherently difficult, which is a big reason that we constantly assess current portfolio positioning and strive to maintain an appropriate level of diversification, which usually includes some assets that may act as a hedge if things quickly take a turn for the worse.

For now, we are watching this situation closely, as we are well aware that oil price shocks have been associated with most of the recessions in the post-WWII period. For the moment prices have increased, and rates of change are beginning to approach levels that have traditionally triggered problems in financial markets. But in our estimation they haven't quite reached a tipping point for the economy just yet. Of course, we will continue to closely monitor the situation, and if energy prices remain on their near-vertical ascent it could be a game changer to our favorable market outlook.

The quarter ended in a feel-good manner with the S&P 500 posting its best first quarter gain since 1998. Investors that missed the news might have guessed that risk had all but disappeared from the investing landscape based on end of quarter values, but those who experienced the full context of the quarter know that perspective to be far from the truth. The global economy is still strengthening, technical conditions are firm, and share prices don't appear to be at exorbitantly high levels yet. Despite this mostly bullish backdrop, there are some very big risks currently swirling that could tip the balance and derail the bull market that began in March 2009. It may not be time to fully de-risk yet, but it's also no time to throw caution to the wind.

For a detailed analysis of Pinnacle's current views, please read the section titled "Market Outlook."

Pinnacle Performance Analysis

Pinnacle Advisory Group managed accounts opened 2011 on an upbeat note as the ongoing bull market in risk assets carried even higher in the first quarter. All portfolios achieved positive first quarter results, and are well above year ago levels.

Composite	First Quarter Composite Return 12/31/10 to 3/31/11	Trailing 12-Month Composite Return 3/31/10 to 3/31/11
Dynamic Conservative	+1.27%	+6.16%
Dynamic Conservative Growth	+2.67%	+9.32%
Dynamic Moderate Growth	+3.71%	+12.01%
Dynamic Appreciation	+4.07%	+11.84%
Dynamic Ultra Appreciation	+4.74%	+10.95%

Please see the last page of this report for important performance-related disclosures.

As has been the case for the past few quarters, equities and other risk assets were the best performers. Energy stocks in particular generated large gains due to oil prices surging over \$100/barrel. Interestingly, select sub-industries within the typically defensive Health Care sector were also among the top performers, which seems to validate our current strategy of owning a barbell, or mix, of attractively valued cyclical and defensive sectors. Among equity alternatives, diversified commodities outperformed the equity benchmark as commodity prices continued to soar, while gold trailed.

Similar to last quarter, fixed income returns were characterized by mild losses in high-quality U.S. Treasuries and gains in lower-quality, credit-sensitive sectors. We expect this to generally persist as long as the economy continues to expand. Merger arbitrage and market neutral strategies, which are currently owned as fixed income alternatives, significantly outperformed the fixed income benchmark.

Top Five Performers of the First Quarter 2011		
Position	Weight	Return
S&P Oil & Gas Exploration & Production ETF	2%	22.7%
Energy Sector SPDR	4%	17.2%
iShares Healthcare Providers ETF	2%	14.9%
iShares Medical Devices ETF	3%	9.1%
Rydex Equal Weight Industrials ETF	4%	7.9%

Bottom Five Performers of the First Quarter 2011		
Position	Weight	Return
iShares 7-10 Year Treasury ETF	4%	-0.4%
Hussman Strategic Growth Fund	0%	-0.5%
iShares 20+ Year Treasury ETF	2%	-1.5%
Capital Markets SPDR	2%	-1.9%
Oppenheimer Developing Markets Fund	0%	-6.7%

Please note that the returns and weightings used for this illustration are based on the Dynamic Moderate Growth portfolio at the end of the period. The individual security returns for other strategies may vary due to trade execution or security selection differences. Securities may have been bought and sold during the quarter; therefore, client returns (which are shown here) may not reflect a security's actual quarterly return. Holdings identified do not represent all of the securities purchased, sold, or recommended for advisory clients. Past performance does not guarantee future results.

Quarterly Portfolio Activity

Entering the New Year, we were looking for an opportunity to modestly increase risk weightings across portfolios in order to better align with the ongoing equity bull market. We accomplished this in stages throughout the quarter, mostly by rotating from defensive to more growth oriented portfolio holdings rather than increasing overall equity weightings. In particular, we were able to take advantage of market volatility that unfolded from mid-February through mid-March, which we had been anticipating.

We currently view portfolios as being at or perhaps a shade above neutral on a volatility basis relative to their benchmarks. While we continue to have a fairly positive outlook, at this point in the bull market where we believe the biggest gains are likely behind us, we are reluctant to shift portfolios meaningfully above benchmark levels of risk. There are no immediate plans to make additional changes at the outset of the second quarter. As always, we continue to monitor portfolio performance and volatility on a daily basis across a variety of timeframes to help guide us as we consider further potential portfolio adjustments.

The following table details the current asset mix across strategies (the net change from the prior quarter is indicated by the number in parentheses):

Composite	Equities	Equity Alternatives	Fixed Income	Fixed Income Alternatives
Dynamic Conservative	8 (0)	7 (-6)	71 (+4)	14 (+2)
Dynamic Conservative Growth	34 (+1)	10 (-5)	49 (+4)	7 (0)
Dynamic Moderate Growth	54 (+4)	6 (-6)	33 (+2)	7 (0)
Dynamic Appreciation	68 (+6.75)	7 (-5)	20.25 (-1.75)	4.75 (0)
Dynamic Ultra Appreciation	91 (+7.5)	7 (-5)	2 (-.5)	0 (-2)

Market Outlook

As the second quarter begins the U.S. economy appears to be gaining steam as a wide array of economic data steadily improves, there is still plenty of liquidity, and there has been a gradual but notable improvement in the U.S. labor market. Inflation worries have surfaced recently, but are mostly driven by oil and food prices, and there appears to be sufficient slack in the economy to counterbalance this inflationary impulse and allow the Federal Reserve to continue their massive bond buying program known as Quantitative Easing 2 (QE2) through the end of June as scheduled.

Intermediate technical market conditions appear solid with long-term trends intact, healthy market participation, and a lack of major divergences. However, there are a few minor technical concerns based on elevated investor sentiment and extreme complacency as measured by implied market volatility. Looking past normal corrective phases that are a healthy part of bull markets, we believe cyclical technical conditions continue to be very supportive for financial markets. Meanwhile, measures of market valuation have drifted somewhat higher as stocks make new cyclical highs, but are still nowhere near the extreme levels that would lead us to shift to a more defensive posture.

Our base case continues to be that stocks will ultimately push to new cycle highs on the back of an improving U.S. economy, extreme liquidity in the system, and firm technical underpinnings. While it's impossible to predict exactly where markets are headed, we think that the S&P 500 should be able to work its way above 1,400, with an outside chance of challenging the previous all-time high of 1,560 reached in both 2000 and 2007.

Of course, there are plenty of risks that remain that could bring about the demise of the bull market, ranging from shorter-term concerns like oil prices and interest rates to longer-term problems like deficits and debt. However, there have been a number of obstacles over the course of this bull market that all seemingly had the potential to send stocks careening back toward their 2008-09 depths. Instead, stocks have impressively overcome each and every roadblock in their path in the past two years, deftly scaling the proverbial "wall of worry."

Our current forecast gives the bull market the benefit of the doubt, but in no way implies that this is the time to be swinging for the fences with portfolio positioning. We believe that benchmark levels of risk are appropriate given the number of asymmetric risks that exist, the presence of significant structural economic headwinds, and an acknowledgement that the most explosive gains of this cycle have likely subsided.

As always, we'll continue to follow the key tenets of our process, and will make the necessary adjustments in accordance with the weight of the evidence as it changes.

Jobs Finally Joining the Party

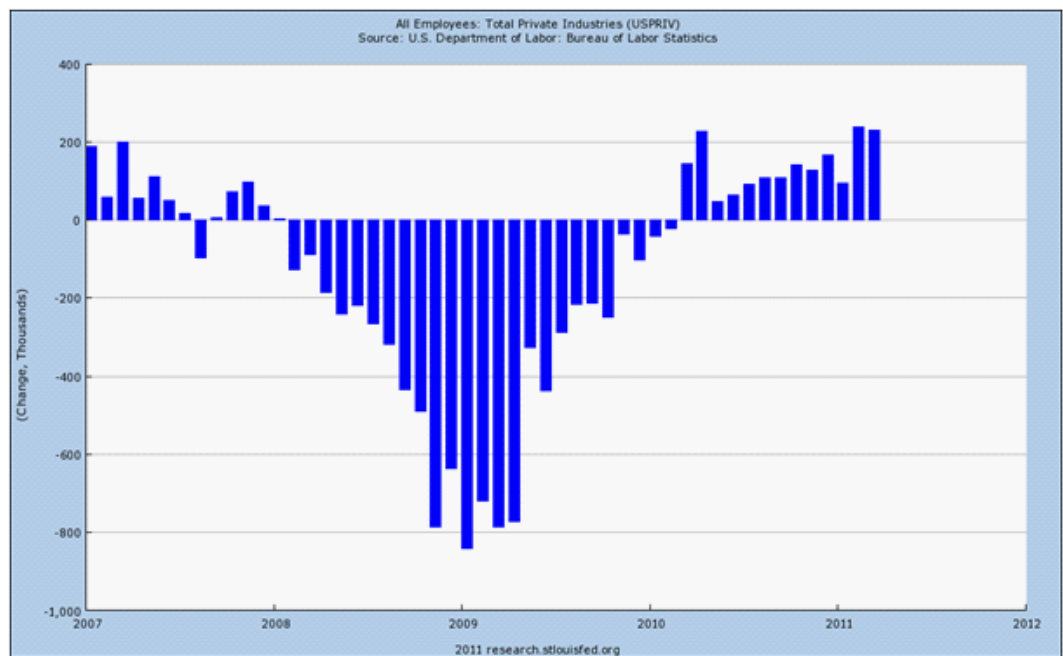
While parts of the economy are performing quite well right now, the one big elephant in the room has been the unfavorable conditions in the labor market, which was badly damaged in the last downturn. The good news is that job growth finally appears to be accelerating somewhat. Private nonfarm payrolls expanded by 564,000 jobs in the first quarter, an increase of 126,000 over the prior three months. Meanwhile, initial unemployment claims, which are considered to be a leading indicator of payrolls, continue to trend lower as less people file for unemployment benefits. They dropped below 400,000 for the first time since 2008, corroborating the improvement in private payrolls. A steady gain in job creation is critical to extend the life of the current business cycle, and could help produce the necessary momentum to achieve a self-sustaining expansion.

Beyond the jobs outlook, credit conditions are steadily improving, and liquidity is still plentiful thanks to low interest rates and QE2. Not all is perfect, though, as inflationary worries are picking up across the globe. However, excess slack in the economy, stagnant wages, high unemployment, and a depressed money multiplier should help to keep the rise in volatile food and energy prices from translating into a sustained inflation outbreak. Elsewhere, there are other parts of the economy that need to be watched closely, such as real wages that are beginning to roll over and house prices that are resuming their decline, but for now the weight of the evidence still supports a continuing business cycle expansion.

Technical conditions also appear quite supportive on an intermediate-term basis. Most global markets are comfortably above important moving averages indicating that the longer-term trend is still intact. In addition, market breadth has

been very strong, seasonal tendencies are still positive, and there are no major divergences that have formed yet. This doesn't mean that there won't be intermittent volatility, but periodic corrections in a bull market are healthy and may create opportunities to make portfolio adjustments at cheaper prices. On balance, the cyclical technical picture is still leaning to the bullish side.

Lastly, valuation may not be cheap, but it also doesn't appear to be at extreme overvaluation levels, either. In our work we find an almost even number of positive and negative valuation factors, which creates a rather neutral overall assessment. Overall, we continue to feel that valuation is becoming slightly overvalued, but not enough to cause undue alarm. As a result, the business cycle and technical conditions currently carry more weight in our decision making process.



Exogenous Risks & The End of QE2

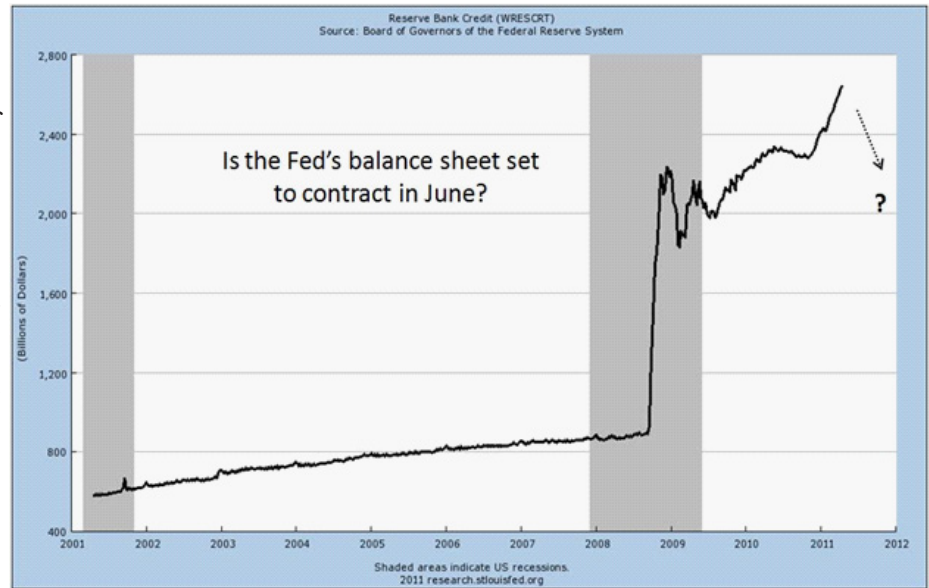
Many of the risks that have emerged recently have been of the exogenous variety, meaning that they're caused by outside forces. The catastrophe in Japan and spreading geopolitical unrest in the Middle East are not part of normal business cycle dynamics, but they certainly have had an impact on economies and asset values. Indeed, supply chain disruptions caused by factory closures in Japan have rippled through the global economy, negatively affecting companies in certain industries such as autos and computer chips. Interestingly, it has also spurred the Bank of Japan into action, as they inject stimulus to a degree not seen since they were attempting their own quantitative easing strategy in the early part of the last decade to fight off deflation. Oil and gas prices are a very real threat, and could force us to alter our view, but as explained earlier, we are not quite there yet.

One of the biggest risks looming just ahead is the eventual unwinding of the excess liquidity that has supported the recovery off the 2009 stock market bottom. Cheap money has largely supported the recovery from the Great Recession, and there is major uncertainty regarding how economies will function as they begin to wean themselves from extraordinary amounts of monetary and fiscal support. China and other emerging countries have already been raising rates for many months, and those markets have exhibited some relative weakness recently. The European Central

Bank also just recently raised rates, despite continuing problems in peripheral European countries, and this creates risk of a policy mistake should they tighten too much. Outside of Japan's emergency stimulus in the wake of their disaster, the U.S. is one of the last countries continuing to prime the pump at full throttle.

The big issue for investors is what happens when the Federal Reserve stops their bond purchases on June 30. This is currently the source of much debate in the investment community, and we don't pretend to have the all the answers. Instituting a quantitative easing program was a measure of last resort, and it is not part of the arsenal of tools the Federal Reserve typically employs under normal circumstances. Adding to the uncertainty is that there is very little precedent in the U.S. to model market behavior at the end of a quantitative easing cycle. One thing we do know is that the stock market can usually handle the first few rate hikes of a traditional tightening cycle. Historical evidence shows that generally stocks continue higher for a time before discounting the eventual drag from higher interest rates. Logically, this makes sense because the Federal Reserve usually doesn't start tightening unless the economy is growing above trend, and there is a time lag. Of course, we don't believe this has been a normal cycle, and how much this program contributed to growth is still the source of much debate among economists and investment analysts.

Ultimately what happens when QE2 ends is what investors might call a "known unknown." While we could take a dogmatic stance on what will happen when the program is terminated, we believe it is prudent to keep an open mind, and be ready to act in a nimble fashion based on the evidence that materializes when this extraordinary program finally comes to a close. But there is also the possibility that the Fed could decide to maintain some stimulus through an extension of



QE2, or perhaps even some sort of new program. Investors have learned not to underestimate the Fed in recent years, as Chairman Bernanke and his cohorts have proven to be very creative and unorthodox in their methods. We would assign a low probability to this barring some sort of unexpected economic downturn between now and the end of June, but it cannot be completely ruled out, either. In the meantime, we will do our best to consider multiple potential outcomes, and plan accordingly.

Conclusion

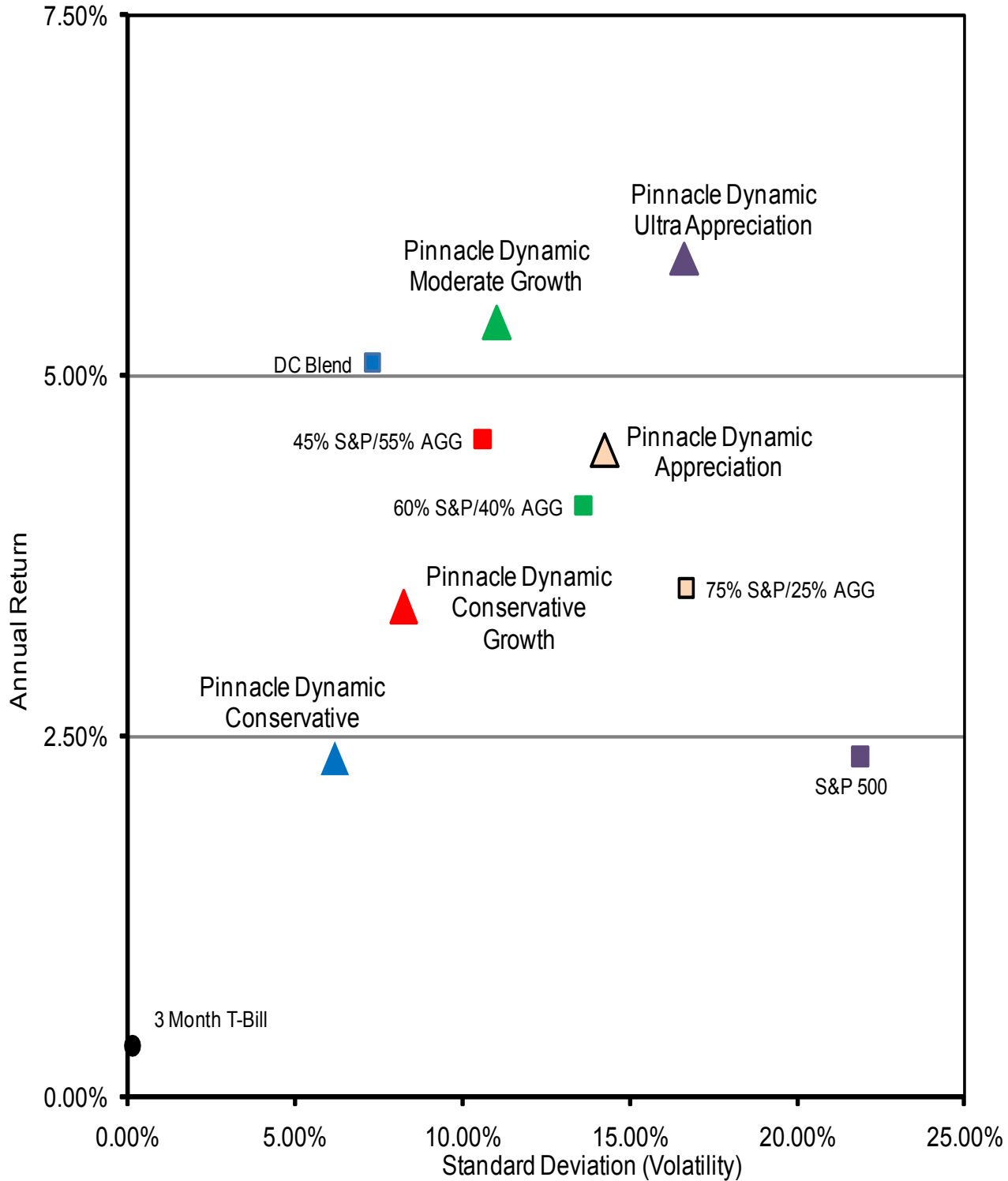
The first quarter brought the return of volatility, but also produced healthy returns. Looking forward, the market will have to navigate a myriad of exogenous and cyclical risks that are present and must be monitored vigilantly. In our view, it seems like an inopportune time for investors to be employing maximum risk strategies at this point in the cycle, but at the same time also too early to prematurely step aside from an ongoing bull market. We still believe that the bull market is intact, and that we will likely achieve higher highs during this cycle. But the most important part of our process is that we are flexible and willing to change with the world around us. As John Maynard Keynes once alluded to, if the facts change, we should change with them.

Pinnacle's views are current as of the date of this communication and are subject to change as economic and market conditions dictate.

The following data corresponds with the chart on page nine:

March 31, 2008 to March 31, 2011		
Asset	Annual Return	Standard Deviation
3 Month T-Bill	0.35%	0.15
DC Blend	5.09%	7.32
Pinnacle Dynamic Conservative	2.35%	6.21
45% S&P/55% AGG	4.56%	10.62
Pinnacle Dynamic Conservative Growth	3.40%	8.25
60% S&P/40% AGG	4.10%	13.61
Pinnacle Dynamic Moderate Growth	5.37%	11.04
75% S&P/25% AGG	3.53%	16.69
Pinnacle Dynamic Appreciation	4.48%	14.24
S&P 500	2.36%	21.89
Pinnacle Dynamic Ultra Appreciation	5.81%	16.63

Pinnacle Composite Portfolios may be compared to a variety of asset classes, blends of asset classes, or mutual fund universes. This chart shows risk and return for four Pinnacle composites. Risk is expressed on the horizontal axis as standard deviation. A high standard deviation means a security is more volatile than a security with a low standard deviation.



Barclays Capital Aggregate Bond Index (AGG) – An unmanaged, intermediate term, market-capitalization weighted index used to represent investment grade bonds being traded in the U.S. The index includes Treasury securities, Government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S.

S&P 500 – An unmanaged, capitalization-weighted index composed of 500 widely held common stocks listed on the NYSE. This index provides a broad snapshot of the overall U.S. equity market. The index selects its companies based upon their market size, liquidity, and sector.

S&P 500 Total Return Index – S&P 500 index including reinvestment of all dividends and distributions.

DC Blend - Comprised of the 30% S&P 500 Total Return/70% Barclays Capital Aggregate Bonds to September 2009 Comprised of 20% S&P 500 Total Return/80% Barclays Capital Aggregate Bonds after September 2009.

45% S&P/55% AGG – Comprised of the S&P 500 Total Return Index and Barclays Capital Aggregate Bond Index.

60% S&P/40% AGG – Comprised of the S&P 500 Total Return Index and the Barclays Capital Aggregate Bond Index.

75% S&P/25% AGG – Comprised of the S&P 500 Total Return Index and Barclays Capital Aggregate Bond Index.

Disclaimer

Pinnacle Advisory Group, Inc. (hereinafter “Pinnacle”) is an investment advisor registered under the applicable provisions of the U.S. Securities and Exchange Commission (SEC).

Pinnacle Dynamic Portfolios Any reference to “Pinnacle’s” portfolio volatility or portfolio performance is based on the actual performance of Pinnacle’s composite portfolio groups. There are five Pinnacle composite portfolios – Dynamic Conservative, Dynamic Conservative Growth, Dynamic Moderate Growth, Dynamic Appreciation, and Dynamic Ultra Appreciation – and each is managed within the constraints of a specific Investment Policy Statement. The composite portfolios are actively managed and the underlying securities and/or percentage holdings in each security can and do change as Pinnacle alters its market outlook based on a continuous evaluation of market and economic conditions. The composite portfolios typically own a diversified mix of no-load or load-waived mutual funds and exchange-traded funds that invest in U.S. and international equities, fixed income securities, and alternative investments such as commodities, real estate, and hedge-fund-like strategies. It is important to note that the returns and volatility shown are accurate representations of past performance, but are not necessarily predictive of future performance or volatility as market conditions can and do change. Returns are calculated using month-end portfolio values. Any and all return or volatility data for the composite portfolios are shown net of all Pinnacle fees and any other related fees (such as fund expense ratios or transaction/trading costs where applicable), include dividends and interest, and are size- and time-weighted. Policy composites include portfolios formerly categorized as “Stock” or “Mutual Fund,” which may have deviated slightly from target model weightings in the past. Policy composite returns may vary from individual Pinnacle client accounts due to deposits or withdrawals from the account, or other client-driven market timing or security selection issues. Pinnacle composite portfolios may be compared to various asset classes, blends of asset classes, indices, or mutual fund universes. The performance and volatility of these asset classes are for comparison purposes only and such performance can be materially different than a Pinnacle composite portfolio.