

CORNERSTONE TOTAL RETURN FUND INC
Form N-CSRS
September 04, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM N-CSR

CERTIFIED SHAREHOLDER REPORT OF REGISTERED
MANAGEMENT INVESTMENT COMPANIES

Investment Company Act file number 811-02363

Cornerstone Total Return Fund, Inc.

(Exact name of registrant as specified in charter)

350 Jericho Turnpike, Suite 206 Jericho, New York

11753

(Address of principal executive offices)

(Zip code)

Theresa M. Bridge

Ultimus Fund Solutions, LLC 350 Jericho Turnpike, Suite 206 Jericho, New York 11753

(Name and address of agent for service)

Registrant's telephone number, including area code: (513) 326-3597

Date of fiscal year end:

December 31, 2012

Date of reporting period:

June 30, 2012

Form N-CSR is to be used by management investment companies to file reports with the Commission not later than 10 days after the transmission to stockholders of any report that is required to be transmitted to stockholders under Rule 30e-1 under the Investment Company Act of 1940 (17 CFR 270.30e-1). The Commission may use the information provided on Form N-CSR in its regulatory, disclosure review, inspection, and policymaking roles.

A registrant is required to disclose the information specified by Form N-CSR, and the Commission will make this information public. A registrant is not required to respond to the collection of information contained in Form N-CSR unless the Form displays a currently valid Office of Management and Budget ("OMB") control number. Please direct comments concerning the accuracy of the information collection burden estimate and any suggestions for reducing the burden to Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. The OMB has reviewed this collection of information under the clearance requirements of 44 U.S.C. ss. 3507.

ITEM 1.

REPORTS TO STOCKHOLDERS.

Cornerstone Total

Return Fund, Inc.

Semi-Annual Report
June 30, 2012
(Unaudited)

CONTENTS

Portfolio Summary	1
Summary Schedule of Investments	2
Statement of Assets and Liabilities	5
Statement of Operations	6
Statement of Changes in Net Assets	7
Financial Highlights	8
Notes to Financial Statements	9
Results of Annual Meeting of Stockholders	14
Investment Management Agreement Approval Disclosure	15
Description of Dividend Reinvestment Plan	16
Proxy Voting and Portfolio Holdings Information	18
Privacy Policy Notice	19
Summary of General Information	22
Stockholder Information	22

Cornerstone Total Return Fund, Inc.
 Portfolio Summary – as of June 30, 2012 (unaudited)

SECTOR ALLOCATION

Sector	Percent of Net Assets
Closed-End Funds	19.7
Information Technology	15.5
Financials	10.9
Health Care	10.4
Consumer Staples	9.0
Energy	8.7
Consumer Discretionary	8.4
Industrials	8.3
Utilities	3.0
Materials	3.0
Telecommunication Services	2.7
Other	0.4

TOP TEN HOLDINGS, BY ISSUER

1. Holding	Sector	Percent of Net Assets
1. Apple, Inc.	Information Technology	6.5
2. Wal-Mart Stores, Inc.	Consumer Staples	3.1
3. Wells Fargo & Company	Financials	3.1
4. Microsoft Corporation	Information Technology	3.1
5. Exxon Mobil Corporation	Energy	2.9
6. International Business Machines Corporation	Information Technology	2.7
7. Eaton Vance Tax-Managed Global Diversified Equity Income Fund	Closed-End Funds	2.5
8. Eaton Vance Risk-Managed Diversified Equity Income Fund	Closed-End Funds	2.3

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9.	Chevron Corporation	Energy	2.2
10.	Coca-Cola Company (The)	Consumer Staples	2.2

1

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Cornerstone Total Return Fund, Inc.
Summary Schedule of Investments – June 30, 2012 (unaudited)

Description	No. of Shares	Value
EQUITY SECURITIES – 99.63%		
CLOSED-END FUNDS – 19.68%		
CONVERTIBLE SECURITIES – 0.05%		
Total Convertible Securities (a)		\$19,006
CORE – 0.12%		
Total Core (a)		42,294
CORPORATE DEBT FUNDS INVESTMENT GRADE-RATED – 1.48%		
Western Asset/Claymore Inflation-Linked Securities & Income Fund	29,732	386,516
Other Corporate Debt Funds Investment Grade-Rated (a)		144,855
		531,371
DEVELOPED MARKET – 0.27%		
Total Developed Market (a)		98,287
GLOBAL – 3.29%		
Clough Global Opportunities Fund	60,413	649,440
Other Global (a)		532,380
		1,181,820
GLOBAL INCOME – 0.15%		
Total Global Income (a)		53,977
INCOME & PREFERRED STOCK – 0.17%		
Total Income & Preferred Stock (a)		61,874
OPTION ARBITRAGE/OPTIONS STRATEGIES – 13.12%		
BlackRock International Growth and Income Trust	61,500	437,880
Description	No. of Shares	Value
OPTION ARBITRAGE/OPTIONS STRATEGIES – (continued)		
Eaton Vance Enhanced Equity Income Fund	45,872	\$486,243
Eaton Vance Enhanced Equity Income Fund II	48,428	514,305
Eaton Vance Risk-Managed Diversified Equity Income Fund	80,913	829,358
Eaton Vance Tax-Managed Buy-Write Opportunities Fund	40,300	500,929
Eaton Vance Tax-Managed Diversified Equity Income Fund	51,439	466,552
Eaton Vance Tax-Managed Global Buy-Write Opportunities Fund	29,700	311,256
Eaton Vance Tax-Managed Global Diversified Equity Income Fund	108,144	897,595
Other Option Arbitrage/Options Strategies (a)		268,510
		4,712,628
REAL ESTATE – 0.91%		
Neuberger Berman Real Estate Securities Income Fund Inc.	73,524	324,976

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SECTOR EQUITY – 0.12%

Total Sector Equity (a) 42,965

TOTAL CLOSED-END FUNDS 7,069,198

CONSUMER DISCRETIONARY – 8.35%

Comcast Corporation - Class A 4,012 128,264

Comcast Corporation - Special Class A 4,250 133,450

Home Depot, Inc. (The) 4,000 211,960

McDonald's Corporation 2,500 221,325

See accompanying notes to financial statements.

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Cornerstone Total Return Fund, Inc.

Summary Schedule of Investments – June 30, 2012 (unaudited) (continued)

Description	No. of Shares	Value
CONSUMER DISCRETIONARY – (continued)		
TJX Companies, Inc. (The)	5,000	\$214,650
Walt Disney Company (The)	6,500	315,250
Other Consumer Discretionary (a)		1,774,846
		2,999,745
CONSUMER STAPLES – 9.05%		
Altria Group, Inc.	7,000	241,850
Coca-Cola Company (The)	10,000	781,900
CVS Caremark Corporation	7,000	327,110
Philip Morris International, Inc.	5,000	436,300
Wal-Mart Stores, Inc.	16,000	1,115,520
Other Consumer Staples (a)		348,690
		3,251,370
ENERGY – 8.75%		
Chevron Corporation	7,500	791,250
ConocoPhillips	6,000	335,280
Exxon Mobil Corporation	12,000	1,026,840
Occidental Petroleum Corporation	4,000	343,080
Other Energy (a)		646,004
		3,142,454
FINANCIALS – 10.88%		
American Express Company	6,000	349,260
JPMorgan Chase & Co.	15,200	543,096
U.S. Bancorp	12,500	402,000
Wells Fargo & Company	33,000	1,103,520
Other Financials (a)		1,509,420
		3,907,296
HEALTH CARE – 10.37%		
Abbott Laboratories	6,000	386,820
Amgen, Inc.	4,000	292,160
Description	No. of Shares	Value
HEALTH CARE – (continued)		
Bristol-Myers Squibb Company	6,000	\$215,700
Johnson & Johnson	6,500	439,140
McKesson Corporation	2,500	234,375
Merck & Company, Inc.	16,000	668,000
Pfizer, Inc.	16,462	378,626
UnitedHealth Group, Inc.	5,500	321,750
Other Health Care (a)		789,455
		3,726,026
INDUSTRIALS – 8.32%		

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Caterpillar Inc.	3,000	254,730
FedEx Corporation	2,500	229,025
General Electric Company	22,000	458,480
Honeywell International Inc.	4,000	223,360
Lockheed Martin Corporation	2,500	217,700
Union Pacific Corporation	2,500	298,275
Other Industrials (a)		1,306,035
		2,987,605
INFORMATION TECHNOLOGY – 15.48%		
Apple, Inc. *	4,000	2,336,000
Intel Corporation	13,000	346,450
International Business Machines Corporation	5,000	977,900
Microsoft Corporation	36,000	1,101,240
Oracle Corporation	18,600	552,420
Other Information Technology (a)		246,009
		5,560,019
MATERIALS – 2.97%		
E.I. du Pont de Nemours and Company	4,800	242,736
Other Materials (a)		824,462
		1,067,198
REAL ESTATE INVESTMENT TRUST – 0.01%		
Total Real Estate Investment Trust (a)		2,490

See accompanying notes to financial statements.

Cornerstone Total Return Fund, Inc.

Summary Schedule of Investments – June 30, 2012 (unaudited) (concluded)

Description	No. of Shares	Value
TELECOMMUNICATION SERVICES – 2.74%		
AT&T, Inc.	17,589	\$627,224
Verizon Communications, Inc.	8,000	355,520
		982,744
UTILITIES – 3.03%		
Total Utilities (a)		1,085,849
TOTAL EQUITY SECURITIES (cost - \$31,490,425)		35,781,994
SHORT-TERM INVESTMENTS – 0.42%		
MONEY MARKET FUNDS – 0.42%		
Fidelity Institutional Money Market Government Portfolio - Class I (cost - \$152,137)	152,137	152,137
TOTAL INVESTMENTS – 100.05% (cost - \$31,642,562)		35,934,131
LIABILITIES IN EXCESS OF OTHER ASSETS - (0.05)%		(18,018)
NET ASSETS – 100.00%		\$35,916,113

(a) Represents issuers not identified as a top 50 holding in terms of market value and issues or issuers not exceeding 1% of net assets individually or in the aggregate, respectively, as of June 30, 2012.

* Non-income producing security.

See accompanying notes to financial statements.

Cornerstone Total Return Fund, Inc.
Statement of Assets and Liabilities – June 30, 2012 (unaudited)

ASSETS

Investments, at value (cost – \$31,642,562)	\$35,934,131
Receivables:	
Investments sold	26,280
Dividends	43,042
Prepaid expenses	4,649
Total Assets	36,008,102

LIABILITIES

Payables:	
Investment management fees (Note D)	33,781
Directors' fees	11,068
Accounting fees (Note D)	3,446
Administration fees (Note D)	2,629
Other accrued expenses	41,065
Total Liabilities	91,989

NET ASSETS (applicable to 6,676,143 shares of common stock outstanding) \$35,916,113

NET ASSET VALUE PER SHARE ($\$35,916,113 \div 6,676,143$) \$5.38

NET ASSETS CONSIST OF

Common stock, \$0.001 par value; 6,676,143 shares issued and outstanding (15,000,000 shares authorized)	\$6,676
Paid-in capital	34,798,255
Accumulated net realized loss on investments	(3,180,387)
Net unrealized appreciation in value of investments	4,291,569
Net assets applicable to shares outstanding	\$35,916,113

See accompanying notes to financial statements.

Cornerstone Total Return Fund, Inc.
 Statement of Operations – for the Six Months Ended June 30, 2012 (unaudited)

INVESTMENT INCOME

Income:

Dividends from investments	\$582,473
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Expenses:

Investment management fees (Note D)	182,634
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Printing	26,717
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Legal and audit fees	25,829
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Directors' fees and expenses	21,427
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Accounting fees (Note D)	19,978
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Administration fees (Note D)	18,263
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Transfer agent fees	16,300
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Custodian fees	4,987
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Insurance	2,561
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Stock exchange listing fees	1,623
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Miscellaneous	1,496
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Total Expenses	321,815
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Net Investment Income	260,658
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NET REALIZED AND UNREALIZED GAIN ON INVESTMENTS

Net realized gain from investments	455,453
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Net change in unrealized appreciation in value of investments	2,581,525
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Net realized and unrealized gain on investments	3,036,978
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NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS	\$3,297,636
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See accompanying notes to financial statements.

Cornerstone Total Return Fund, Inc.
Statement of Changes in Net Assets

	For the Six Months Ended June 30, 2012 (Unaudited)	For the Year Ended December 31, 2011
INCREASE/(DECREASE) IN NET ASSETS		
Operations:		
Net investment income	\$ 260,658	\$ 73,506
Net realized gain/(loss) from investments	455,453	(63,160)
Net change in unrealized appreciation in value of investments	2,581,525	371,615
Net increase in net assets resulting from operations	3,297,636	381,961
Dividends and distributions to stockholders:		
Net investment income	(260,658)	(73,075)
Return-of-capital	(3,617,247)	(5,159,948)
Total dividends and distributions to stockholders	(3,877,905)	(5,233,023)
Common stock transactions:		
Proceeds from rights offerings of 0 and 2,628,010 shares of newly issued common stock, respectively	—	14,559,175
Offering expenses associated with the rights offering	—	(93,487)
Proceeds from 88,898 and 62,277 shares newly issued in reinvestment of dividends and distributions, respectively	492,500	476,036
Net increase in net assets from capital stock transactions	492,500	14,941,724
Total increase/(decrease) in net assets	(87,769)	10,090,662
NET ASSETS		
Beginning of period	36,003,882	25,913,220
End of period	\$ 35,916,113	\$ 36,003,882

See accompanying notes to financial statements.

Cornerstone Total Return Fund, Inc.
Financial Highlights

Contained below is per share operating performance data for a share of common stock outstanding, total investment return, ratios to average net assets and other supplemental data for each period indicated. This information has been derived from information provided in the financial statements and market price data for the Fund's shares.

	For the Six Months Ended June 30, 2012 (Unaudited)	For the Years Ended December 31,*								
		2011	2010	2009	2008	2007				
PER SHARE OPERATING PERFORMANCE										
Net asset value, beginning of period	\$ 5.47	\$ 6.65	\$ 7.19	\$ 7.75	\$ 17.00	\$ 20.28				
Net investment income/(loss) #	0.04	0.02	(0.00)+	(0.02)	0.12	0.14				
Net realized and unrealized gain/(loss) on investments	0.46	0.05	0.68	1.31	(5.64)	0.64				
Net increase/(decrease) in net assets resulting from operations	0.50	0.07	0.68	1.29	(5.52)	0.78				
Dividends and distributions to stockholders:										
Net investment income	(0.04)	(0.02)	—	—	(0.12)	(0.14)				
Net realized capital gains	—	—	—	—	—	(0.06)				
Return-of-capital	(0.55)	(1.32)	(1.46)	(1.90)	(3.77)	\$13.2	\$1.0	\$0.6	\$14.7	
Partnership Interest	8.6	(0.1)	-	8.5						
Preferred Equity	31.9	1.7	-	33.6						
Common Equity	370.7	3.2	-	373.9						
Total Investments	\$424.4	\$5.7	\$0.6	\$430.7						

The following table provides a summary of changes in the fair value of investment assets and liabilities measured using Level 3 inputs during the nine months ended December 31, 2009 (in millions):

	Fair Value 3/31/2009	Net Unrealized Appreciation (Depreciation)	Net New Investments (Divestitures)	Conversion of Security from Debt to Equity	Fair Value 12/31/2009
Debt	\$8.3	\$6.0	\$1.8	\$(1.3)	\$14.7

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Partnership Interest	6.7	(0.2)	2.0	-	8.5
Preferred Equity	16.4	7.7	8.2	1.3	33.6
Common Equity	351.4	24.7	(2.3)	-	373.9
Total Investments	\$382.8	\$38.2	\$9.7	\$-	\$430.7

The total unrealized gains (losses) for the three and nine month periods ended December 31, 2009 included in earnings that related to assets still held at December 31, 2009 were \$5,714,505 and \$38,208,870, respectively

5. Income Taxes

We operate to qualify as a RIC under Subchapter M of the IRC. In order to qualify as a RIC, we must annually distribute at least 90% of our taxable ordinary income, based on our tax year, to our shareholders in a timely manner. Ordinary income includes net short-term capital gains but excludes net long-term capital gains. A RIC is not subject to federal income tax on the portion of its ordinary income and long-term capital gains that are distributed to its shareholders, including “deemed distributions” discussed below. As permitted by the Code, a RIC can designate dividends paid in the subsequent tax year as dividends of current year ordinary income and net long-term gains if those dividends are both declared by the extended due date of the RIC’s federal income tax return and paid to shareholders by the last day of the subsequent tax year. We have distributed or intend to distribute sufficient dividends to eliminate taxable income for our completed tax years. If we fail to satisfy the 90% distribution requirement or otherwise fail to qualify as a RIC in any tax year, we would be subject to tax in such year on all of our taxable income, regardless of whether we made any distributions to our shareholders. Additionally, we are also subject to a nondeductible federal excise tax of 4% if we do not distribute at least 98% of our investment company ordinary taxable income before the end of our tax year. We have a calendar tax year end of December 31. For the tax years ended December 31, 2009 and 2008, CSC and CSVC qualified to be taxed as RICs. We intend to meet the applicable qualifications to be taxed as a RIC in future years. Management feels it is probable that we will maintain our RIC status for a period longer than one year. However, either company’s ability to meet certain portfolio diversification requirements of RICs in future years may not be controllable by such company.

(continued)

A RIC may elect to retain its long-term capital gains by designating them as a “deemed distribution” to its shareholders and paying a federal tax of 35% on the long-term capital gains for the benefit of its shareholders. Shareholders would then report their share of the retained capital gains on their income tax returns as if it had been received and report a tax credit for the tax paid on their behalf by the RIC. Shareholders then add the amount of the “deemed distribution,” net of such tax, to the basis of their shares.

As permitted by the Internal Revenue Code, a RIC can designate dividends paid in the subsequent tax year as dividends of the current year ordinary taxable income and long-term capital gains if those dividends are both declared by extended due date of the RIC’s federal income tax return and paid to shareholders by the last day of the subsequent tax year. For tax years ended December 31, 2009 and 2008, we declared and paid ordinary dividends in the amount of \$2,993,310 and \$12,256,745, respectively.

As a RIC, we are also subject to a nondeductible federal excise tax of 4% if we do not distribute at least 98% of our investment company ordinary taxable income before the end of our tax year. For the tax years ended December 31, 2009 and 2008, we distributed 100% of our investment company ordinary taxable income. Therefore, we have made no tax provisions for income taxes on ordinary taxable income for the tax years ended December 31, 2009 and 2008.

For the tax year ended December 31, 2009, we have estimated net long-term capital gains of \$2,327,150 for tax purposes and \$1,682,616 for book purposes, which we elected to retain and treat as deemed distributions to our shareholders. Likewise, for the tax year ended December 31, 2008, we had net long-term capital gains of \$14,922,751 for tax purposes and \$15,936,644 for book purposes; which we also elected to retain and treat as deemed distributions to our shareholders. In order to make the election to retain capital gains, we incurred federal taxes on behalf of our shareholders in the amount of \$814,502 and \$5,222,964 for the tax years ended December 31, 2009 and 2008, respectively. As of December 31, 2009, we did not have any undistributed long-term capital gains since they are being treated as distributed through the “deemed distribution.”

CSMC, a wholly owned subsidiary of CSC, is not a RIC and is required to pay taxes at the current corporate rate. CSC sponsors a qualified defined benefit pension plan which covers its employees and employees of certain of its wholly owned portfolio companies. Deferred taxes related to the qualified defined pension plan are recorded as incurred.

6. Employee Stock Option Plans

On July 20, 2009, shareholders approved the Company’s 2009 Stock Incentive Plan (the “2009 Plan”), which provides for the granting of stock options to employees and officers of the Company and authorizes the issuance of common stock upon exercise of such options for up to 140,000 shares. All options are granted at or above market price, generally expire up to ten years from the date of grant and are generally exercisable on or after the first anniversary of the date of grant in five annual installments. Options to purchase 38,750 shares at a price of \$76.74 (market price at the time of the grant) were granted on October 19, 2009 and remain outstanding, thus leaving a total of 101,250 options available for future grant.

The Company previously granted stock options under its 1999 Stock Option Plan (the “1999 Plan”), as approved by shareholders on July 19, 1999. The 1999 Plan expired on April 19, 2009. Options previously made under the Company’s 1999 Stock Option Plan and outstanding on July 20, 2009 continue in effect governed by provisions of the 1999 plan. All options granted under the 1999 Plan were granted at or above market price, generally expire up to ten years from the date of grant and are generally exercisable on or after the first anniversary of the date of grant in five to ten annual installments.

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Notes to Consolidated Financial Statements

(continued)

We recognize compensation cost over the straight-line method for all share-based payments granted on or after that date and for all awards granted to employees prior to April 1, 2006 that remain unvested on that date. The fair value of stock options are determined on the date of grant using the Black-Scholes pricing model and are expensed over the vesting period of the related stock options. Accordingly, for the quarter and nine months ended December 31, 2009, we recognized compensation expense of \$190,652 and \$473,703, respectively.

As of December 31, 2009, the total remaining unrecognized compensation cost related the 2009 Plan and 1999 Plan non-vested stock options was \$2,871,764, which will be amortized over the weighted-average service period of approximately 4.2 years. The following table summarizes the 2009 Plan and the 1999 Plan price per option at grant date using the Black-Scholes pricing model:

Date of Issuance	Black-Scholes Pricing Model Assumptions				
	Weighted Average Fair Value	Expected Dividend Yield	Risk-Free Interest Rate	Expected Volatility	Expected Life (in years)
<u>2009 Plan</u>					
October 19, 2009	\$ 25.36	1.04%	2.36%	37.6%	5
<u>1999 Plan</u>					
July 30, 2008	\$ 29.93	0.62%	3.36%	20.2%	5
July 21, 2008	\$ 27.35	0.67%	3.41%	20.2%	5
July 16, 2007	\$ 41.78	0.39%	4.95%	19.9%	5
July 17, 2006	\$ 33.05	0.61%	5.04%	21.2%	7
May 15, 2006	\$ 31.28	0.64%	5.08%	21.1%	7

The following table summarizes activity in the 2009 Plan and the 1999 Plan as of December 31, 2009:

	Number of shares	Weighted-Average Exercise Price
<u>2009 Plan</u>		
Balance at March 31, 2009	–	\$ –
Granted	38,750	76.74
Exercised	–	–
Canceled	–	–
Balance at December 31, 2009	38,750	\$76.74
<u>1999 Plan</u>		
Balance at March 31, 2009	107,900	\$114.78
Granted	–	–
Exercised	–	–
Canceled	–	–
Balance at December 31, 2009	107,900	\$114.78
Combined Balance at December 31, 2009	146,650	\$104.72

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Notes to Consolidated Financial Statements

(continued)

At December 31, 2009, the range of exercise prices and weighted-average remaining contractual life of outstanding options was \$65.00 to \$152.98 and 4.2 years, respectively. The number of options exercisable under the 2009 Plan and the 1999 Plan, at December 31, 2009, was 35,960 with a weighted-average exercise price of \$110.30. No options were exercised during the nine months ended December 31, 2009.

7. Summary of Per Share Information

	Three Months Ended		Nine Months Ended	
	December 31		December 31	
	2009	2008	2009	2008
Investment income	\$.68	\$ 2.74	\$ 1.34	\$ 3.42
Operating expenses	(.21)	(.20)	(.59)	(.59)
Interest expense	–	–	–	–
Income taxes	(.01)	(.01)	(.02)	(.03)
Net investment income	.46	2.53	.73	2.80
Distributions from undistributed net investment income	(.40)	(2.56)	(.80)	(3.28)
Net realized gain (loss) on investments	(.22)	2.87	.22	2.86
Net increase (decrease) in unrealized appreciation of investments	.84	(17.94)	10.80	(26.29)
Treasury stock repurchase *	–	–	–	1.40
Change in pension plan funded status	–	–	(.07)	–
Stock option expense	.05	.04	.13	.10
Increase (decrease) in net asset value	.73	(15.06)	11.01	(22.41)
Net asset value:				
Beginning of period	121.26	142.74	110.98	150.09
End of period	\$121.99	\$127.68	\$121.99	\$127.68
Shares outstanding at end of period (000s omitted)	3,742	3,742	3,742	3,742

* Net increase is due to purchases of Common Stock at prices less than beginning period net asset value.

8. Contingencies and Commitments

From time to time the Company may be liable for claims against its portfolio companies. We do not believe the effects of such claims would have a material impact on our results of operations and financial condition.

The Company has future commitments, subject to specific conditions, to invest up to \$5,061,482 in six portfolio companies.

(continued)

9. New Authoritative Accounting Guidance

As discussed in *Note 3 – Significant Accounting Policies*, on July 1, 2009, the Accounting Standards Codification became FASB's officially recognized source of authoritative U.S. generally accepted accounting principles applicable to all public and non-public non-governmental entities, superseding existing FASB, AICPA, EITF and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered non-authoritative. The switch to ASC affects the way companies refer to U.S. GAAP in financial statements and accounting policies. Citing particular content in the ASC involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph Structure.

New authoritative accounting guidance under ASC Topic 715, "Compensation – Retirement Benefits," provides guidance related to an employer's disclosures about plan assets of defined benefit pension or other post-retirement benefit plans. Under ASC Topic 715, disclosures should provide users of financial statements with an understanding of how investment allocation decisions are made, the factors that are pertinent to an understanding of investment policies and strategies, the major categories of plan assets, the inputs and valuation techniques used to measure the fair value of plan assets, the effect of fair value measurements using unobservable inputs on changes in plan assets for the period and significant concentrations of risk within plan assets. The disclosures required by ASC Topic 715 will be included in our financial statements beginning with the financial statements for the year ended March 31, 2010.

New authoritative accounting guidance (Accounting Standards Update No. 2009-5) under ASC Topic 820 provides guidance for measuring the fair value of a liability in circumstances in which a quoted price in an active market for the identical liability is not available. In such instances, a reporting entity is required to measure fair value utilizing a valuation technique that uses (i) the quoted price of the identical liability when traded as an asset, (ii) quoted prices for similar liabilities when traded as assets, or (iii) another valuation technique that is consistent with the existing principles of ASC Topic 820, such as an income approach or market approach. The new authoritative guidance also clarifies that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. The foregoing new authoritative accounting guidance under ASC Topic 820 became effective for our financial statements beginning October 1, 2009 and did not have a significant impact on our financial statements.

Further new authoritative accounting guidance (Accounting Standards Update No. 2009-12) under ASC Topic 820 provides guidance for measuring the fair value of investments in certain entities that calculate net asset value per share or its equivalent; provided that the investment does not have a readily determined fair value and the net asset value is calculated in a manner that is consistent with ASC Topic 946, "Financial Services – Investment Companies," as of the reporting entities measurement date, including the measurement of all or substantially all of the underlying investments of the investee in accordance with Topic 820. In such instances, a reporting entity is permitted to estimate the fair value of an investment using the net asset value per share. The disclosures required by ASU 2009-12 became effective for our financial statements for the quarter ended December 31, 2009 and did not have a significant impact on our financial statements.

10. Subsequent Events

The Company has evaluated all subsequent events through February 4, 2010, the date of the filing of this Form 10-Q.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with our consolidated financial statements, and notes thereto, for the year ended March 31, 2009, included in the 2009 Form 10-K. Operating results for the three and nine months ended December 31, 2009 are not necessarily indicative of the results for the year ended March 31, 2010 or any future period.

Forward-Looking Statements

The information contained herein may contain "forward-looking statements" based on our current expectations, assumptions and estimates about us and our industry. These forward-looking statements involve risks and uncertainties. Words such as "believe," "anticipate," "estimate," "expect," "intend," "plan," "will," "may," "might," "could," other similar expressions identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. Our actual results could differ materially from those anticipated in the forward-looking statements as a result of several factors more fully described in "Risk Factors" and elsewhere in this Form 10-Q, and in our Form 10-K for the year ended March 31, 2009. The forward-looking statements made in this Form 10-Q related only to events as of the date on which the statements are made. We undertake no obligation to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

Results of Operations

Net asset value at December 31, 2009 was \$456,445,923, equivalent to \$121.99 per share. Assuming reinvestment of all dividends and tax credits on retained long-term capital gains, the December 31, 2009 net asset value reflects a decrease of 3.4% during the past twelve months.

	December 31, 2009	December 31, 2008
Net assets	\$456,455,923	\$477,738,322
Shares outstanding	3,741,638	3,741,638
Net assets per share	\$121.99	\$127.68

The composite measure of our financial performance in the Consolidated Statements of Operations is captioned "Increase (decrease) in net assets from operations" and consists of three elements. The first is "Net investment income," which is the difference between our income from interest, dividends and fees and our combined operating and interest expenses, net of applicable income taxes. The second element is "Net realized gain (loss) on investments," which is the difference between the proceeds received from disposition of portfolio securities and their stated cost. The third element is the "Net increase (decrease) in unrealized appreciation of investments," which is the net change in the market or fair value of our investment portfolio, compared with stated cost. It should be noted that the "Net realized gain (loss) on investments" and "Net increase (decrease) in unrealized appreciation of investments" are directly related in that when an appreciated portfolio security is sold to realize a gain, a corresponding decrease in net unrealized appreciation occurs by transferring the gain associated with the transaction from "unrealized" to "realized." Conversely, when a loss is realized on a depreciated portfolio security, an increase in net unrealized appreciation occurs.

Net Investment Income

Interest income of \$773,076 for the nine months ended December 31, 2009 decreased from \$1,052,625 for the nine months ended December 31, 2008 as a result of lower interest rates, decrease in excess cash, and the sale of unrestricted marketable securities in October 2008. During the nine months ended December 31, 2009 and 2008, we recorded dividend income from the following sources:

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

(continued)

	Nine Months Ended December	
	2009	2008
Alamo Group Inc.	\$ 509,454	\$ 509,454
CapitalSouth Partners	20,528	20,519
Dennis Tool Company	33,333	37,499
Encore Wire Corporation	245,205	245,205
Heelys, Inc.	0	9,317,310
Kimberly-Clark Corporation	0	89,529
PETsMart, Inc.	0	18,000
The RectorSeal Corporation	1,877,870	480,000
TCI Holdings, Inc.	60,953	60,953
The Whitmore Manufacturing Company	469,467	120,000
Other	0	51,039
	\$3,216,810	\$10,949,508

Net Realized Gain on Investments

Net realized gains on investments for the nine months ended December 31, 2009 totaled \$1,639,995 before tax provisions while net realized gains on investments for the nine months ended December 31, 2008 totaled \$15,936,644.

During the nine months ended December 31, 2009, we sold all of our shares of Dennis Tool Company generating proceeds of \$4,763,416, which does not include an additional \$659,361 held in escrow; resulting in a net realize gain of \$1,433,472 before tax provisions. In addition, we received \$206,522 from Essex Capital Corporation representing a contingent payment in connection with a previous investment in Pharma Fab, Inc. that was written off in 2007.

Net Increase (Decrease) in Unrealized Appreciation of Investments

Set forth in the following table are the significant increases and decreases in unrealized appreciation by portfolio company:

	Three Months Ended December 31		Nine Months Ended December 31	
	2009	2008	2009	2008
Alamo Group Inc.	\$2,830,300	\$(3,537,875)	\$14,151,500	\$(14,859,075)
All Components, Inc.	1,000,000	(2,399,999)	7,612,999	(9,599,999)
Balco, Inc.	-	-	1,400,000	1,500,000
Encore Wire Corporation	(4,086,750)	6,130,125	4,086,750	10,216,875
Heelys, Inc.	465,866	(16,305,293)	4,285,963	(16,305,293)
Media Recovery, Inc.	1,900,000	(3,600,000)	(1,100,000)	(9,100,000)
Palm Harbor Homes, Inc.	(2,984,947)	(9,818,901)	(2,984,947)	(5,891,341)
The RectorSeal Corporation	5,300,000	(4,200,000)	2,600,000	(16,900,000)
The Whitmore Manufacturing Company	-	(1,000,000)	2,400,000	(1,000,000)

During the nine months ended December 31, 2009, the value of our investments increased by \$40,419,753. The largest increases in unrealized appreciation are attributable to Alamo Group, Inc., which increased \$14,151,500; Heelys, Inc., which increased \$4,285,963; Encore Wire Corporation, which increased \$4,086,750, all due to an increase in their respective stock prices; and All Components, Inc., which increased \$7,612,999 as a result of debt

reduction on its senior credit facility. Offsetting the increases were a \$2,984,947 reduction in Palm Harbor Homes, Inc. due to a decrease in their stock price; and a \$1,100,000 reduction in Media Recovery, Inc. caused by slowdowns in segments of their business.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

(continued)

Portfolio Investments

During the quarter ended December 31, 2009, we made investments of \$753,000 in existing portfolio companies.

We have agreed, subject to certain conditions, to invest up to \$5,061,482 in six portfolio companies.

Financial Liquidity and Capital Resources

At December 31, 2009, we had cash and cash equivalents of approximately \$4.7 million. Pursuant to Small Business Administration (SBA) regulations, cash and cash equivalents of \$2.6 million held by Capital Southwest Venture Corporation (CSVC) may not be transferred or advanced to us without the consent of the SBA. Under current SBA regulations and subject to the SBA's approval of its credit application, CSVC would be entitled to borrow up to \$20.6 million. With the exception of a capital gain distribution made in the form of a distribution of the stock of a portfolio company in the fiscal year ended March 31, 1996, we have elected to retain all gains realized during the past 40 years. Retention of future gains is viewed as an important source of funds to sustain our investment activity. Approximately \$16.0 million of our investment portfolio is represented by unrestricted publicly-traded securities, and represent a source of liquidity.

Funds to be used by us for operating or investment purposes may be transferred in the form of dividends, management fees or loans from The RectorSeal Corporation and The Whitmore Manufacturing Company, wholly-owned portfolio companies, to the extent of their available cash reserves and borrowing capacities.

Management believes that our cash and cash equivalents and cash available from other sources described above are adequate to meet our expected requirements. Consistent with our long-term strategy, the disposition of investments from time to time may also be an important source of funds for future investment activities.

Application of Critical Accounting Policies and Accounting Estimates

There have been no changes during the quarter ended December 31, 2009 to the critical accounting policies or the areas that involve the use of significant judgments and estimates we described in our Annual Report on Form 10-K for the fiscal year ended March 31, 2009.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

We are subject to financial market risks, including changes in marketable equity security prices. We do not use derivative financial instruments to mitigate any of these risks.

Our investment performance is a function of our portfolio companies' profitability, which may be affected by economic cycles, competitive forces, foreign currency fluctuations and production costs including labor rates, raw material prices and certain commodity prices. Most of the companies in our investment portfolio do not hedge their exposure to raw material and commodity price fluctuations. However, the portfolio company with the greatest exposure to foreign currency fluctuations generally hedges its exposure. All of these factors may have an adverse effect on the value of our investments and on our net asset value.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

(continued)

Our investment in portfolio securities includes fixed-rate debt securities which totaled \$14,687,432 at December 31, 2009, equivalent to 3.3% of the value of our total investments. Generally, these debt securities are below investment grade and have relatively high fixed rates of interest; therefore, minor changes in market yields of publicly-traded debt securities have little or no effect on the values of debt securities in our portfolio and no effect on interest income. Our investments in debt securities are generally held to maturity and their fair values are determined on the basis of the terms of the debt security and the financial condition of the issuer.

A portion of our investment portfolio consists of debt and equity securities of private companies. We anticipate little or no effect on the values of these investments from modest changes in public market equity valuations. Should significant changes in market valuations of comparable publicly-owned companies occur, there may be a corresponding effect on valuations of private companies, which would affect the value and the amount and timing of proceeds eventually realized from these investments. A portion of our investment portfolio also consists of restricted common stock of publicly-owned companies. The fair values of these restricted securities are influenced by the nature of applicable resale restrictions, the underlying earnings and financial condition of the issuers of such restricted securities and the market valuations of comparable publicly-owned companies. A portion of our investment portfolio also consists of unrestricted, freely marketable common stock of publicly-owned companies. These freely marketable investments, which are valued at the public market price, are directly exposed to equity price risks in that a change in an issuer's public market equity price would result in an identical change in the fair value of our investment in such security.

Item 4. Controls and Procedures

As of the end of the period covered by this report, an evaluation was performed under the supervision and with the participation of our management, including the Chairman of the Board and President and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15 and 15d-15 of the Securities Exchange Act of 1934). Based on that evaluation, the Chairman of the Board and President and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that the information required to be disclosed is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and is accumulated and communicated to management, including the Chairman of the Board and President and Chief Financial Officer, as appropriate, to allow timely decisions regarding such required disclosure.

During the fiscal quarter ended December 31, 2009, there were no changes to the internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are currently the subject of certain legal actions. In our judgment, none of the lawsuits currently pending against us, either individually or in the aggregate, is likely to have a material adverse effect on our business, results of operations, or financial position.

We, Capital Southwest Corporation and CSVC, have been named in a lawsuit filed on August 27, 2007 in the United States District Court of the Northern District of Texas, Dallas Division, against Heelys, Inc. (“Heelys”) and their Chief Executive Officer, Chief Financial Officer, the directors who signed their registration statement with the Securities and Exchange Commission in connection with their December 7, 2006 initial public offering (“IPO”), and their underwriters for the IPO. The complaint alleges violations of Sections 11 and 15 of the Securities Act of 1933 and the plaintiffs are seeking compensatory damages in an unspecified amount, as well as reasonable costs and expenses incurred in the action, including counsel fees and expert fees. Similar suits were also filed in 2007 and 2008 in the United States District Court of the Northern District of Texas making substantially similar allegations under Sections 11, 12 and 15 of the Securities Act of 1933, and seeking substantially similar damages.

These lawsuits were transferred to a single judge, and consolidated into a single action, with a consolidated complaint filed on March 11, 2008. During a mediation conducted by the Hon. Nicholas H. Politan (ret.), Plaintiffs and Defendants reached a settlement pursuant to which Defendants will pay Plaintiffs and a proposed plaintiff settlement class a total of \$7.5 million. Heelys, Inc. also reached an agreement in principal with its insurers for their insurance policies to fund the majority of this settlement amount. On July 31, 2009, the Court preliminarily approved the settlement and scheduled a final fairness hearing for November 17, 2009 to consider final approval of the settlement. On November 17, 2009, the federal judge presiding over the consolidated securities class action approved the settlement and signed a Final Judgment and Order of Dismissal with prejudice with respect to the lawsuit.

Heelys, Inc., its former Chief Executive Officer, its former Chief Financial Officer, and its directors who signed the Company's registration statement filed with the Securities and Exchange Commission in connection with its December 7, 2006 initial public offering (the "IPO")—along with us, Capital Southwest Corporation and CSVC, and the underwriters for the Heelys, Inc. IPO—are defendants in a lawsuit originally filed on May 16, 2008 by individual shareholder Carl Dick in the County Court of Law No. 1, Dallas County, Texas. This lawsuit asserts claims that are substantially similar to those asserted in the consolidated class action described above. The Plaintiff's second petition alleges violations of Sections 11, and 15 of the Securities Act of 1933, Sections 33(A), (C), and (F) of the Texas Securities Act and Section 27.01 of the Texas Business and Commerce Code. Defendants withdrew their previously-filed special exceptions to Plaintiff's petition seeking to have all claims dismissed on August 21, 2009. Plaintiff and Defendants agreed to settle this case for \$5.25 million. Heelys' insurance company paid approximately \$2.0 million of the settlement amount, and Heelys paid the remainder. Pursuant to the settlement agreement, the lawsuit was dismissed with prejudice on September 18, 2009.

Item 1A. Risk Factors

There have been no material changes to our risk factors disclosed in Item 1A, “Risk Factors”, in our Annual Report on Form 10-K for the fiscal year ended March 31, 2009.

Item 6. Exhibits

(a) Exhibits

Exhibit 31.1- Certification of Chairman of the Board and President required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), filed herewith.

Exhibit 31.2- Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Exchange Act, filed herewith.

Exhibit 32.1- Certification of Chairman of the Board and President required by Rule 13a-14(b) or Rule 15d-14(b) of the Exchange Act and Section 1350 of Chapter 63 of Title 18 of the United States Code, furnished herewith.

Exhibit 32.2- Certification of Chief Financial Officer required by Rule 13a-14(b) or Rule 15d-14(b) of the Exchange Act and Section 1350 of Chapter 63 of Title 18 of the United States Code, furnished herewith.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CAPITAL SOUTHWEST CORPORATION

Date: February 4, 2010

By: /s/ Gary L. Martin
Gary L. Martin, Chairman of the Board and President

Date: February 4, 2010

By: /s/ Tracy L. Morris
Tracy L. Morris, Chief Financial Officer