

Dear Client,

We hope you are well. The time has come for us to make some adjustments in our models and change some managers.

Model Changes

You may recall our last note to you about three weeks ago where we discussed a new product available from Barclays Bank. That product which is based on what they call the Dynamic VIX Index (ETN, symbol XVZ) is eminently useful in reducing downside risk from the stock market. We mentioned in that note (please let us know if you'd like another copy of that) that we were in the process of studying this product. We have concluded that it does significantly help reduce risk in portfolios and that it provides a much stronger bear market hedge than the product we have been using (VQT or VEQTOR Index) since it incorporates only VIX futures and no S&P 500 exposure. The product acts as a direct hedge to large cap domestic stock exposure and it also acts as an "effective" hedge against exposure to domestic small cap stocks, convertible bonds, and international large cap stocks. It helps hedge exposure to those other asset classes due to their high correlations with domestic large cap. We asked Barclays to back test correlations to the 1990's and the relationships we noted over the last five years holds even for the back tested data. Based on data provided to us from Barclays the effective ratio is 85% for the asset classes being hedged to 15% for the new Dynamic VIX product. Therefore our new models will be as shown:

Model Portfolios

	<i>Allocation (%)</i>								
<i>Asset Class</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>6</i>	<i>7</i>	<i>8</i>	<i>9</i>
<i>Stocks - Large/Mid Cap Value</i>	0.00%	3.53%	6.38%	7.65%	9.78%	12.75%	15.73%	18.70%	21.25%
<i>Stocks - Large Cap Growth</i>	0.00%	0.00%	0.00%	1.70%	2.55%	4.68%	5.31%	5.95%	9.35%
<i>Cash - Money Market Funds</i>	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%
<i>Fixed Income</i>	64.00%	57.00%	48.00%	39.00%	30.00%	16.00%	8.00%	0.00%	0.00%
<i>International Bond</i>	7.00%	7.00%	7.00%	7.00%	8.00%	14.00%	15.00%	15.00%	7.00%
<i>Real Estate</i>	2.20%	3.10%	4.00%	5.00%	6.00%	7.50%	8.00%	11.00%	11.00%
<i>Stocks - International Large</i>	8.16%	1.19%	1.96%	3.36%	5.10%	4.89%	6.80%	9.35%	13.60%
<i>Stocks - International Small</i>	0.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	4.75%	5.00%
<i>Bond Convertible</i>	1.11%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	1.70%
<i>Stocks - Small Cap Value</i>	1.15%	1.19%	2.76%	4.08%	5.31%	5.95%	5.95%	5.95%	5.74%
<i>Natural Resources</i>	3.30%	4.70%	6.70%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%
<i>Volatility</i>	1.84%	1.79%	2.71%	3.71%	4.76%	5.74%	6.71%	7.80%	9.11%
<i>Alternative Investments</i>	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	8.00%	7.00%
<i>Total</i>	100.0%	100 %	100 %	100 %	100.0%	100 %	100%	100%	100.0%
<i>Projected Return</i>	6.05%	6.52%	7.02%	7.53%	8.01%	8.52%	8.93%	9.45%	9.94%
<i>Risk (Standard Deviation)</i>	4.60%	5.60%	7.00%	7.70%	8.90%	10.10%	11.40%	12.60%	14.00%

Here in question and answer format is some other important points:

(some repeated from our last note);

What is the overriding goal with the additions of the alternative asset class and volatility?

We are trying to hedge against something known in the industry as “tail risk.” Tail risk is the risk of rare events occurring like the severe market decline in 2008. Events like that where most asset classes experience severe declines are typical when some sort of “contagion” in financial markets spreads. Theoretically those events are supposed to occur very infrequently in fact 2008 may have been an event that should only occur once every few hundred years. Unfortunately they occur with much higher frequency than statistics would suggest. We have spent a lot of time over the last two years researching this issue and evaluating different strategies to lessen the impact of these events. Our research indicates that hedge fund strategies and new strategies like volatility can help insulate you against those events.

What is an Exchange Traded Note (ETN)?

An ETN is a debt vehicle issued by a firm like Barclays or Deutsche Bank for example that trades like an ETF and is broken down into small share values like \$10. ETN’s unlike ETF’s though do have counterparty risk since they represent unsecured debt issued by the firm that creates them. This fact has increased our caution in using these vehicles.

How does Dynamic VIX react to market volatility?

The index tends to spike when market volatility; which is nearly always associated with a severe decline, spikes. As an example in October of 2008 when the S&P 500 dropped nearly 17% Dynamic VIX surged 77%; dramatically easing that blow. In May 2010 when we experienced the so called “flash crash” Dynamic VIX returned 10.8%.

What Happens when the Market Spikes Upward?

Dynamic VIX will give back some of its gains, but not symmetrically meaning it has increased much more on market declines with their associated volatility and given back much less on market spikes. In April 2009 when the market began a recovery and increased 5.6% Dynamic VIX dropped 8% and remained level for the remainder of the year. Here are the returns for the index for the last few years:

Year	2006	2007	2008	2009	2010	2011 ¹
Dynamic VIX Return	3.66%	37.18%	132.29%	0.74%	20.66%	-2.04%

Dynamic VIX has provided downside protection when it is most needed as in 2008. This fact combined with contingent rebalancing should enhance the hedging effect.

¹ Through August 2011

How come this has not been implemented sooner?

Two reasons:

First these products have only become available over the last few months and we needed time to study it and secondly we know that Dynamic VIX will give back some of its gain when the VIX index settles back after a spike. With the VIX index at 40 of late we were waiting to see if it dropped back to 30 or below before we began rebalancing portfolios.

How should I view this component of my holdings?

Many of you may wonder why we will be holding something that may seem to provide a modest or low return for long periods of time. That behavior is very evident in the table of returns we show above, in particular in 2009 when the market returned 26% yet Dynamic VIX returned .74%. You may question this. Our overriding goal though is to reduce volatility in client's portfolios since volatility is an enormous threat to wealth creation and retention. We wish we could somehow bundle this product with the assets it is meant to hedge against so the low return in times of low market volatility were not so evident. We know it is common for us to look at our portfolio as an unbundled combination of various assets. It is instead important to view the portfolio as a whole and recognize that we have carefully specifically chosen the components for the way they interact as a whole--to have lower risk for a given level of return.

When will rebalancing start?

Probably within the next few days.

Which managers are changing and why?

The following managers are to be sold: Fairholme, Artio International, DFA Large Cap Value, and the Keeley Fund.

The following managers will be added: Tocqueville International Value, Templeton Inst Foreign Sm Co, The Yacktman Fund, and the Nicholas Equity Income Fund.

The four managers being removed were on our watch list for a year or so -- their diminished performance in comparison to their best fit benchmark has been monitored and found wanting. The new funds will be discussed in more detail in future newsletters.

Please let us know if you have any questions or concerns or you do not want us to make these changes to your portfolio.

News About Stonegate

Our web site has undergone a significant redesign to improve its look and organization we invite you to review it and comment:

www.stonegatewealth.com