



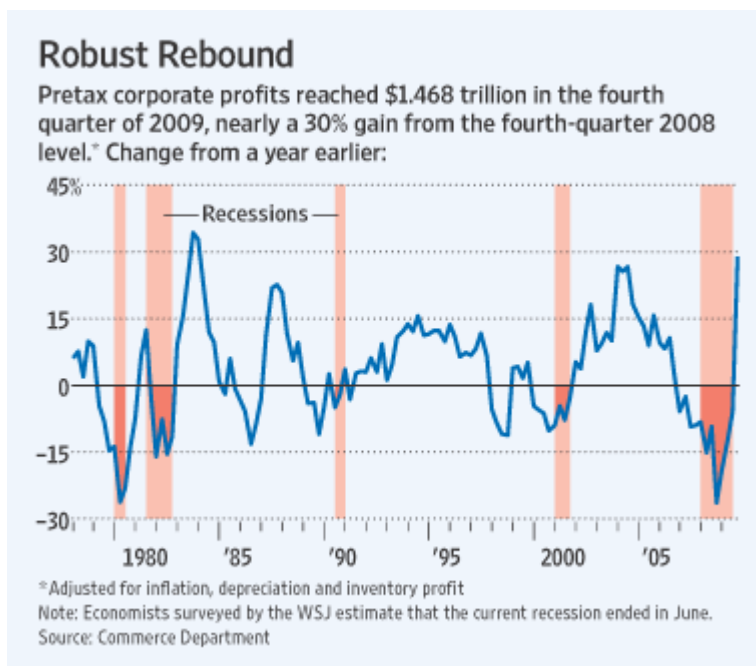
May 12, 2010

*Dear Client,*

In this edition of our newsletter we cover a couple of important topics, We illustrate the issue of contingent rebalancing (with an overview written by Richard Westhelle) and why it is so important to our portfolio management process. Then we discuss a concept known as “risk drag.” After a brief mention of the restoration of IRA minimum required distributions we provide you with news about the Stonegate team.

### **Market Performance**

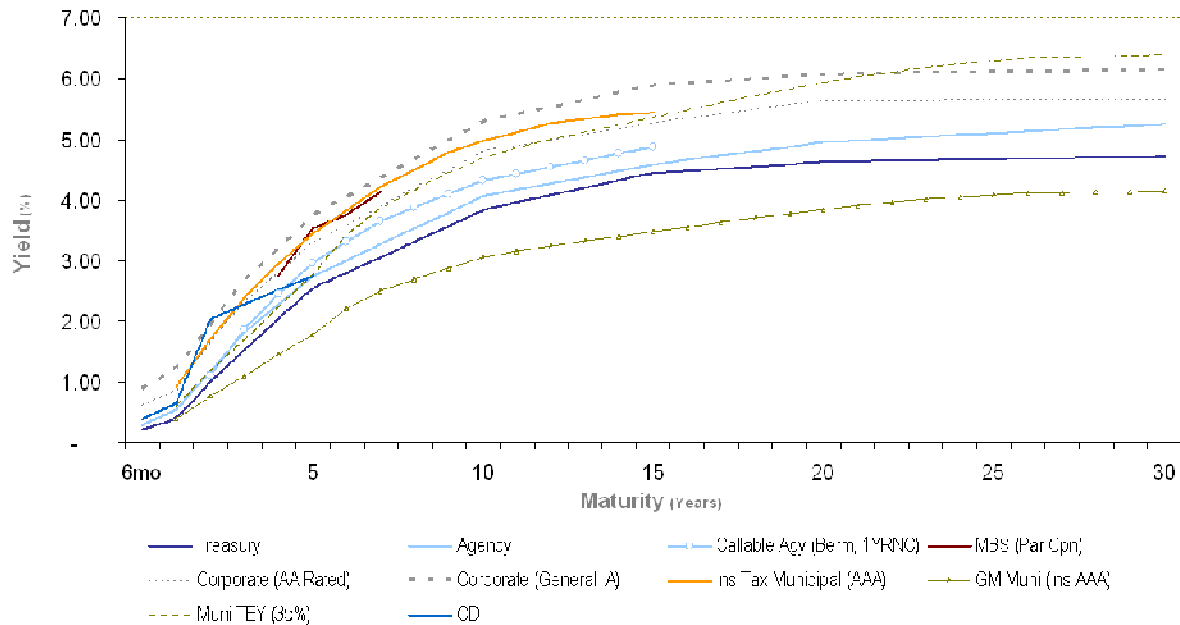
Equity markets continued their recovery this year reflecting the significant improvement in corporate profits. Pretax profits are 30.6% higher than a year earlier—the biggest increase in 25 years.



The S&P 500 has now exceeded the 1200 milestone for the first time since late September 2008. We are also seeing significant a recovery in REIT's with real estate up nearly 10% for the year to date. Some have expressed concern about REIT's with commercial properties experiencing high vacancy rates and the possibility that some of the poorer managed REIT's could have banks decide not to renew their loans when they mature. While that might be true for some REIT's we

think this is an opportune time for better managed REIT's to pick up excellent properties at fire sale prices, enabling them to be positioned well for the economic recovery. Apparently markets are anticipating exactly that.

Interest rates are still very low and it's a challenge to obtain significant yield terms less than 4 years. The yield curve shown below is evidence of the difficulty<sup>1</sup>.



Yields in the 1-5 year range are very low with Agencies less than 3% and municipals less than 2%. We can get higher yield by extending our ladders to the 5-10 year time range but we are reluctant to do that for two reasons:

- We anticipate interest rates rising as the economy improves and the demand for credit increases due to the enormous federal budget deficit. As bonds mature the proceeds will probably be reinvested at higher rates in the near term (2-3 years).
- We do not want to lock in these low yields for any significant period of time.

Higher yield could be obtained by investing in corporate bonds. The multiple risks associated with corporate bonds are not worth taking for the additional yield. Those risks include default risk, credit downgrade risk, etc.

### **The Importance of Contingent Rebalancing for Your Portfolio**

Stonegate has purchased and implemented a state of the art system that allows us to rebalance all our accounts on a "contingent" basis. We acquired the system to enhance your investment performance and be able to efficiently test your portfolio to see if any asset class or holding exceeds a threshold that indicates rebalancing should be performed. I think we have explained

<sup>1</sup>Courtesy of our bond experts at BMO Capital markets

the benefits of contingent rebalancing too many of you in our personal meetings—probably using a yellow pad. Rich Westhelle has written a detailed explanation that illustrates the benefits more quantitatively. We trust you will find it informative.

### ***What is Contingent Rebalancing?***

Contingent rebalancing is the use of a group of assets whose correlations are different from one another to create a systematic process for "buying low" and "selling high". (If assets are all correlated with one another little benefit is gained.) Contingent rebalancing means not rebalancing on a specific day, month etc., instead rebalancing when your portfolio actually needs it. Our state of the art system can check frequently to see if your portfolio needs to be rebalanced by comparing your allocation against the model allocation, if any asset class exceeds or falls below a threshold or “band “ that encompasses what we feel is an appropriate range we consider making trades to bring it back into balance. At Stonegate Wealth Management, we have read various studies as well as conducted them, and we have found that using a +/-20% tolerance threshold for assets in your portfolio best ensures that your asset allocation remains balanced over time.

### **Example:**

Your portfolio allocates 40% to Stocks and 60% to Bonds. A rise in interest rates causes a drop in demand for Stocks and an increase in demand for Bonds. As a result, in 2010, the Stocks in your portfolio depreciate 25%, and the Bonds appreciate 25%.

The table below illustrates what would happen if such an event were to occur and triggered the 20% threshold--signaling it is time to rebalance your portfolio:

### **2010 Stocks +25%, Bonds -25%**

*(Based upon a \$100,000 Portfolio, Example Only)*

### **Original Allocation:**

<b>Asset Class</b>	<b>Allocation</b>	<b>\$ Amount</b>
Stocks	40%	\$ 40,000.00
Bonds	60%	\$ 60,000.00
Total	100%	\$100,000.00

### **Asset Levels at the end of 2010:**

<b>Asset Class</b>	<b>Allocation</b>	<b>\$ Amount</b>	<b>Plus 20% Threshold Amount</b>	<b>Minus 20% Threshold Amount</b>
Stocks	28.6%	\$ 30,000.00	\$48,000.00	\$32,000.00
Bonds	71.4%	\$ 75,000.00	\$ 72,000.00	\$48,000.00

In this instance, the portfolio's percentage of Stocks exceeds -20% of the amount that the portfolio's asset allocation called for, and the situation triggers rebalancing.

### **Post Rebalance Allocation:**

<b>Asset Class</b>	<b>Allocation</b>	<b>\$ Amount</b>
Stocks	40.0%	\$ 42,000.00
Bonds	60.0%	\$ 63,000.00
Total	100%	\$105,000.00

As you can see above, we restored our original asset allocation of 40% Stocks, and 60% Bonds which allowed your portfolio to sell Bonds at a "high" price, and buy Stocks at a "low" price; the ideal situation.

### ***What is the value of rebalancing?***

Rebalancing is like pruning a shrub in your front yard. If you let it grow uncontrolled, eventually you find that some of the branch(es) will have grown faster than the others. The result is a shrub tilted heavily in one direction. It appears "out of balance" and hampers the growth of the entire plant as a whole.

However, if you trim the shrub back on a regular basis, all of its branches are able to grow in unison over time for the greater good of the entire plant. Keep in mind, just as you don't want to prune your shrub too little, you also don't want to prune too often as both carry the effect of stunting meaningful growth

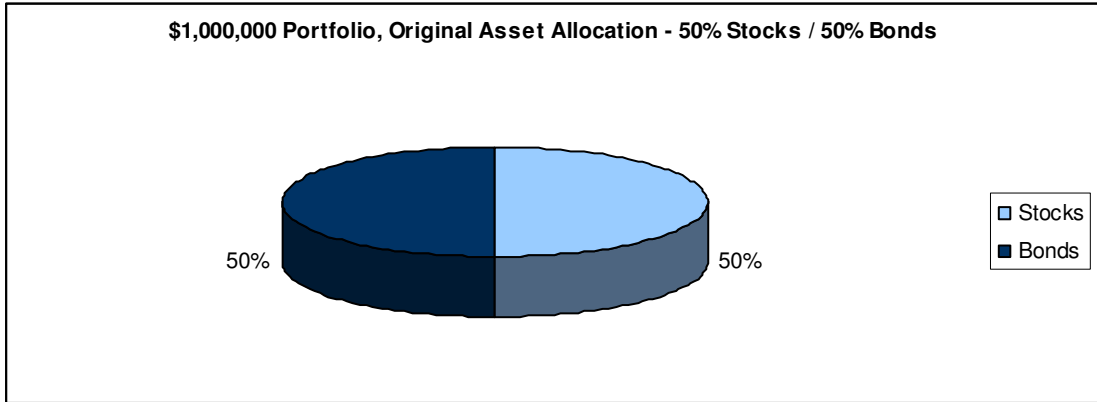
The same principle applies to rebalancing in portfolio management.

For simplicity's sake, we will use two asset classes, Stocks, and Bonds. These two asset classes in any given year are either negatively correlated, or have a weak positive correlation. (Note: Correlation measures the degree of relationship between two assets and/or asset classes. A positive correlation means the asset class's move in the same direction in any given market. A negative correlation means they move in opposite directions of one another in any given market)

In our example, we will use two portfolios, Portfolio A and Portfolio B. Both portfolios will originally be allocated to 50% Stocks / 50% Bonds. At the end of each year, with Portfolio A, we will do nothing, with Portfolio B, we will rebalance to restore back to the original asset allocation.

The tables and graphs below illustrate the value derived from rebalancing a \$1,000,000 portfolio on an annual basis at the end of each year over a period of 10 year:

**Figure 1: This is what both Portfolio A and Portfolio B look like in our original asset allocation.**

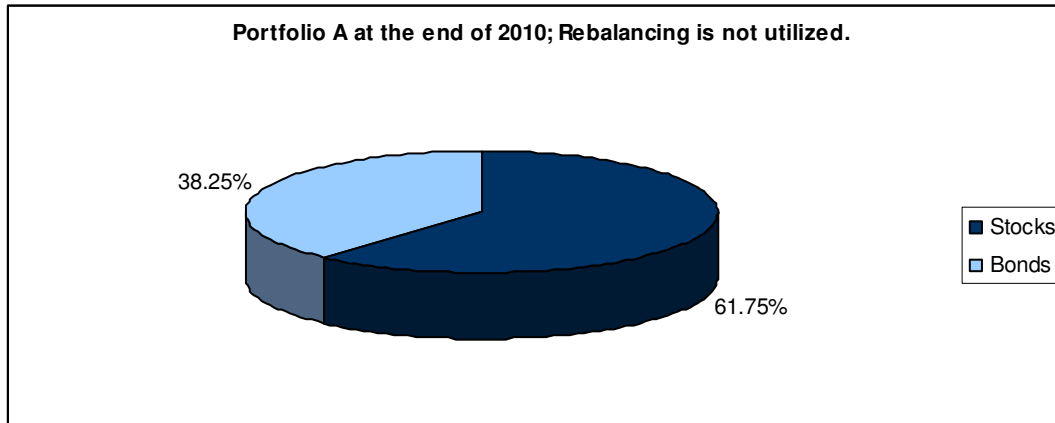


**Figure 2: The table below illustrates the outcome of Portfolio A.**

Returns	Asset Classes		Fair Market Value (FMV)	
	Stocks	Bonds	Stocks	Bonds
2010	10%	5%	\$ 550,000.00	\$ 525,000.00
2011	-10%	7%	\$ 495,000.00	\$ 561,750.00
2012	20%	6.00%	\$ 594,000.00	\$ 595,455.00
2013	40%	2.50%	\$ 831,600.00	\$ 610,341.38
2014	-22%	11%	\$ 648,648.00	\$ 677,478.93
2015	7%	5%	\$ 694,053.36	\$ 711,352.87
2016	15%	2%	\$ 798,161.36	\$ 725,579.93
2017	50%	-5%	\$1,197,242.05	\$ 689,300.93
2018	17%	10%	\$1,400,773.19	\$ 758,231.03
2019	-10%	3%	\$1,260,695.87	\$ 780,977.96
Total Assets	\$2,041,673.83			
Total 10-Yr Return	104.2%			

As you can see from the above table, Portfolio A no longer has its original asset allocation and has become weighted more heavily towards our riskier asset; Stocks. This result can be detrimental to a client who is nearing retirement if the stock market decides to take a dive, driving stock values down and the portfolio's value down with it. This is why we put an emphasis on rebalancing and maintaining your investment strategy.

**Figure 3: The graph below shows how Portfolio A's asset allocation has deviated from our model after 10 years without rebalancing.**

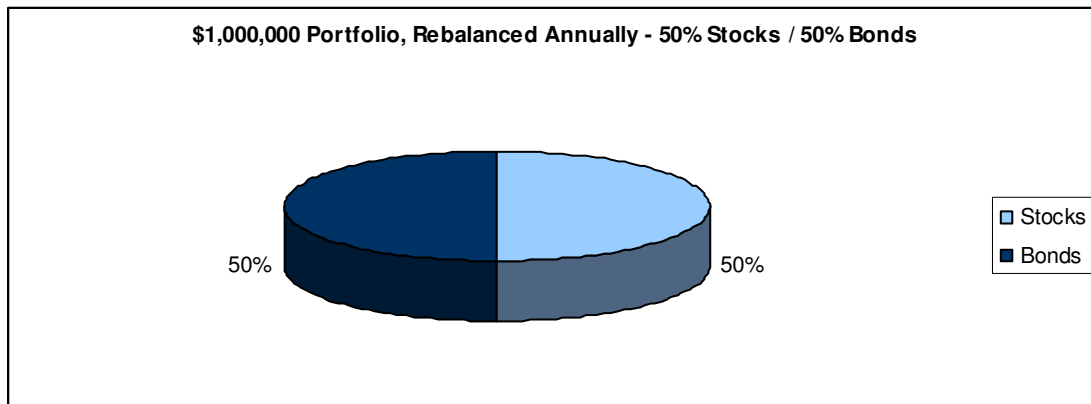


**Figure 4: The table below illustrates the outcome of Portfolio B which rebalances at the end of each year.**

Returns	Asset Classes		Fair Market Value (FMV)		Post-Rebalance FMV	
	Stocks	Bonds	Stocks	Bonds	Stocks	Bonds
2010	10%	5%	\$ 550,000.00	\$ 525,000.00	\$ 537,500.00	\$ 537,500.00
2011	-10%	7%	\$ 483,750.00	\$ 575,125.00	\$ 529,437.50	\$ 529,437.50
2012	20%	6.00%	\$ 635,325.00	\$ 561,203.75	\$ 598,264.38	\$ 598,264.38
2013	40%	2.50%	\$ 837,570.13	\$ 613,220.98	\$ 725,395.55	\$ 725,395.55
2014	-22%	11%	\$ 565,808.53	\$ 805,189.07	\$ 685,498.80	\$ 685,498.80
2015	7%	5%	\$ 733,483.72	\$ 719,773.74	\$ 726,628.73	\$ 726,628.73
2016	15%	2%	\$ 835,623.04	\$ 741,161.30	\$ 788,392.17	\$ 788,392.17
2017	50%	-5%	\$1,182,588.25	\$ 748,972.56	\$ 965,780.41	\$ 965,780.41
2018	17%	10%	\$1,129,963.08	\$1,062,358.45	\$1,096,160.76	\$1,096,160.76
2019	-10%	3%	\$ 986,544.69	\$1,129,045.58	\$1,057,795.14	\$1,057,795.14
Total Assets    \$2,115,590.27 Total 10- Year Return     111.56%						

Here you can see that Portfolio B has maintained its original asset allocation on an annual basis at the end of each year, due to systematic rebalancing. As a result Portfolio B has outperformed Portfolio A over the past 10 years by 7.36% total return. Rebalancing has added additional value to Portfolio B by approximately 0.74% per year.

**Figure 5: The graph below shows Portfolio B's asset allocation has remained balanced after 10 years utilizing rebalancing on an annual basis.**



**Bottom Line:**

As you will see below by comparing the end result of the two tables below, even though we used the same two asset classes and the exact same return assumptions over a 10-year period of time, the portfolio value of Portfolio B ended up being significantly higher than Portfolio A because of periodic rebalancing.

**Figure 6: Difference in Performance between Portfolio A and Portfolio B**

	<b>Portfolio A</b>	<b>Portfolio B</b>	<b>Difference</b>
Total Assets	\$2,041,673.83	\$2,115,590.27	\$73,916.44
Total 10-Yr Return	104.2%	111.56%	7.39%

***Facilitating Rebalancing***

Rebalancing works best for portfolios that include:

- Assets that are not completely correlated with each other for example international bonds and domestic bonds or commodities and equity.
- Assets that have higher volatility; for example commodities and REIT's

Perhaps Michael Kitces said it best:

***“Rebalancing introduces a genuine opportunity to create excess return in a diversified portfolio, as a systematic active management process of rebalancing volatile assets that do not always move in the same direction can indirectly create buy-low-sell-high opportunities over time. Consequently, a rebalanced multi-asset class portfolio can actually outperform a portfolio that is invested 100% in the highest returning asset, while a merely diversified-but-not-rebalanced portfolio cannot.”<sup>2</sup>***

So if you suddenly see a flurry of trades in your statements it usually means we have rebalanced your account.

*The system we purchased (Tamarac) cost us a significant amount per year, but we are confident that it is money well spent and enhances your portfolio performance.*

### **Risk Drag**

Investors are always attracted to high return investments and asset classes. What many investors are not aware of is the negative effect volatility may have on the actual returns experienced by those who invest in volatile assets. Let’s take the following example:

Lucent Stock Returns							
	1997	1998	1999	2000	2001	2002	2003
Annual Return %	74%	176%	37%	-81%	-53%	-75%	125%
Ending Value of \$1 Million (\$M)	\$1.74	\$4.80	\$6.58	\$1.25	\$0.59	\$0.15	\$0.33
Average Annual Return over the period:					29%		
Compound Annual Return over the Period:					-15%		

The difference between the average return of 29% and the compound or geometric return of -15% is due to what we call risk drag. Periods of loss erode so much value that gains have to work twice as hard first to restore value lost and then to grow principle. Effective portfolio management seeks to reduce volatility and reduce the chances of large losses—enhancing long term wealth creation for you.

“Risk Drag” is such an important concept that we believe it warrants a further example. Some S&P 500 sectors such as Information Technology have a high *average* return. What many do not realize is that the *actual compounded* return experienced by an investor is much lower. In fact it is over 5% lower annually. The following table illustrates the effect of volatility (“risk drag”) on the various S&P sectors:

### **Historical Average Returns and Volatility of S&P Sectors 1990-2008, including Geometric Mean and Volatility Drag.**

<sup>2</sup> The Kitces Report, Michael Kitces, December 2009.

	Geometric Mean Return	Arithmetic Mean Return	Volatility Drag	Cumulative Growth of \$10,000
Energy	11.00%	12.61%	1.62%	\$65,436
Health Care	9.94%	12.51%	2.57%	\$55,056
Consumer Staples	9.91%	11.04%	1.13%	\$54,786
Information Technology	7.78%	13.34%	5.56%	\$38,520
Industrials	7.63%	9.64%	2.00%	\$37,566
Financials	7.05%	10.92%	3.87%	\$34,085
Utilities	6.75%	9.27%	2.52%	\$32,406
Consumer Discretionary	6.20%	8.63%	2.43%	\$29,528
Materials	5.56%	7.44%	1.88%	\$26,484
Telecom Services	3.95%	7.18%	3.23%	\$20,084

If you decided to hold only the highest return asset; information technology, your portfolio over the 18 years would have increased from \$10,000 to \$38,520. If you chose to invest only in Energy your portfolio would have grown to over \$65,000 or 76% more. This is certainly a counter-intuitive result and a critical concept— if you invest in the portfolio with the highest average single year return you actually have less wealth if you maintained that holding over many years than if you invested in a portfolio with lower return but with less volatility. This is an extremely important concept to understand. Stonegate tries to reduce volatility drag by:

- Choosing assets whose price movements tend to cancel each other
- Leaning towards value rather than growth. Value stocks typically have higher dividends—stocks with higher dividends are usually less volatile.
- Avoiding sectors with high volatility like technology.
- Incorporating volatile assets only if their addition to a portfolio lowers risk.
- Including alternative asset classes like market neutral that have lower downside risk
- Choosing managers that have lower downside capture.

### **IRA Required Minimum Distributions (RMD's)**

They are back! We got our one and only reprieve in 2009 from taking required minimum distributions. As you may recall Congress suspended the requirement in the closing weeks of 2008 as one response to the stock markets near crash. Unfortunately this rule is restored for 2010 so all 2010 RMD's will be based on the account values (totaled for all your traditional IRA's) as of Dec 31 2009. You will receive no credit in 2010 for RMD's mistakenly taken in 2009. QCD or Qualified Charitable Distributions have expired this year though we expect them to be reinstated by Congress. If you are interested in making a gift to a charity out of your IRA and you are over 70 1/2 you should hold off taking your RMD to the end of the year. We will let you if and when the QCD gets reinstated.

## **Stonegate News**

Cary was recently interviewed regarding how to invest your money in the current market on PBS's Nightly Business Report segment on March 24th, 2010 . You may download the video [here](#). Her segment begins at the 9:05 mark and ends at 9:47.

Cary was also interviewed by Warren Boroson a reporter for [www.NewJerseynewsroom.com](http://www.NewJerseynewsroom.com). You may view the article here:

<http://www.newjerseynewsroom.com/economy/a-financial-planner-who-is-especially-good-for-widows>

Cary was also recently quoted in the following publications:

- 1.) Money Magazine, April, 2010 Edition - this was an exclusive which interviewed a young couple adjusting with financial situation after the main breadwinner was laid off from work over a year ago. You may read the entire article [here](#).
- 2.) Orlando Business Journal - this article discusses the prospect of investing in Gold, and the opinions of several financial experts. You may read the entire article [here](#).

Stephen Craffen organized a series of investment symposiums for NAPFA members in Newark, NJ, Waltham, MA, and Bethesda, MD. on the topic portfolio management and recent advancements in the field. The series was well received with 75 advisors attending the NJ and MA sessions alone. Steve is Study Group and Education Director for NAPFA's North Eastern/Mid-Atlantic Region.

As always please call us with any questions.

***Regards,***

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