



January 21, 2010

Dear Client,

In this Stonegate Wealth Management newsletter we'll cover several general items about the markets and provide you with specific insight on technical investment terms that you may have heard us talking about. We'll discuss the markets, converting to Roth IRAs, the difference between Time Weighted Return (TWR) and Internal Rate of Return (IRR), and the characteristics and benefits of convertible bonds in the sections below.

But first of all, some great news about Stonegate!

Stonegate Wealth Management is pleased to announce that it has merged with Family Financial Research, LLC, of Clermont, Florida.

Family Financial Research, LLC, has experienced steady growth even in the past two years of economic downturn. Cary Carbonaro, President and Founder of Family Financial, joins Steve Craffen, Tom Geraghty, and Craig Marson in the leadership circle of the combined firm, which will be called Stonegate Wealth Management and will have offices in Fair Lawn, NJ, Huntington, NY, and Clermont, FL. Like Tom Geraghty, Cary Carbonaro is a member of Ed Slott's Elite IRA Advisor Group. Rich Westhelle, of Family Financial Research, LLC, a graduate of Ohio State University with a Bachelor's in Financial Planning, joins Cary at Stonegate and focuses on financial planning and analysis. (Cary was just featured in a Wall Street Journal article on retirement planning, here's the link:

<http://online.wsj.com/article/SB10001424052748704533904574544013345372556.html>

The fact that both firms operate on a fee-only basis and share a common vision of the importance of the fiduciary responsibility for their clients was a significant factor in the decision to join forces.

Now let's talk about the market and some interesting changes that might be of benefit to you.

Market Performance

Imagine if someone told you the first week in March that stocks would be up over 20% for the year by December.

If someone told us that, we'd have said that they were dreaming. By early March stocks were down over 20%, and it looked as if 2009 was going to be a continuation of 2008. You'll recall that the S&P 500 was down 37% last year.

But what a turnaround! We have experienced a 40% swing in the market's value in 2009. The question arises whether this is a real rally or just a rebound from an overreaction. There is no clear answer to that question at this point. However, the changes that we have made to Stonegate's models and the contingent

rebalancing we've done should enable us to both capture gains once an asset class reaches our "sell threshold" and dampen any potential downside. And once again the market's movements provide evidence that market timing is a fool's errand.

Roth Conversions

We are reviewing clients' tax returns and other information to determine if it makes sense to consider a Roth conversion for 2010. Why? Because next year the income limit for Roth conversions (roughly 100K of modified adjusted gross income in 2009) is suspended, and the tax you owe on the conversion can be paid over two years, 2010 and 2011. The conversion might make sense depending on a few factors:

How Much Time Do You Have Until Retirement?

As a rule of thumb, the older you are, the less sense it makes to convert a traditional IRA to a Roth. You'll have less time to make up for what you paid in taxes on the conversion.

Do You Plan to Leave All of Your IRA to Your Heirs?

In that case, it might make sense for you to convert even if you are older. Unlike traditional IRAs, Roth IRAs require no minimum withdrawals during the life of the IRA owner. If the surviving spouse inherits the Roth account, he or she need not take any minimum withdrawals either. With a regular IRA, however, you must begin taking taxable withdrawals from that account no later than the year after you turn 70 1/2. So you lose out on the chance for that money to continue to compound without paying taxes. That can mean a lot less money for your heirs. Furthermore, conversion to a Roth will reduce your taxable estate by the amount of income tax you pay to convert. This may reduce estate taxes for your heirs.

Will Your Income Tax Bracket Drop After Retirement?

Converting a regular tax-deductible IRA to a Roth IRA does not make sense when you expect to drop into a much lower income tax bracket after you retire (say, from 25% to 15%). You would pay income tax on the conversion at your current high rate. Instead, let the money compound in your regular IRA and pay taxes at your lower rate in retirement. On the other hand, if you expect your tax rate to drop a few points after retirement (say, from 28% to 25%), conversion is probably the right move.

Other points to consider:

- If you are younger than 59 1/2 and you pay the conversion tax by making a withdrawal from the IRA to a Roth IRA conversion, you will owe a 10% penalty on the withdrawal amount.
- Converting to a Roth IRA means you will not have to make the required minimum distributions (RMD) when you reach 70 1/2. Depending on your circumstance the lowered income may make your Social Security less likely to be taxed.
- If you will need your IRAs to support your lifestyle, the conversion to a Roth IRA may not make sense.
- Stonegate Wealth Management can review your IRAs with you at the right time and recommend workable decisions for you.

Stonegate uses sophisticated software programs to analyze these options if you're thinking about converting to Roth IRAs. If you feel this is something you want to consider, please contact us so we can review the options for you.

With both Tom Geraghty and Cary Carbonaro as members of Ed Slott's Elite IRA Advisor Group, Stonegate Wealth Management is well positioned to advise you if you have questions about whether it is appropriate to convert your traditional IRAs to Roth IRAs.

Time Weighted Rate of Return (TWR) vs. Internal Rate of Return (IRR)

Clients frequently ask us to explain the difference between time-weighted return and internal rate of return. Here is a summary of the difference.

The TWR measures investment performance (income and price changes) as a percentage of capital "at work," eliminating the effects of capital flows into and out of the portfolio. The IRR provides a measure of the growth of a portfolio in absolute terms, so it is useful for determining if a portfolio is growing fast enough to meet a future need or goal.

IRR is influenced by the timing and size of capital flows; a money manager typically has no control over the timing or size of contributions and withdrawals. Therefore, the IRR is unsuitable for determining the relative skill of the manager.

Also, because it is influenced by the timing and size of capital flows, the IRR cannot be compared to a market index or the results of other asset managers. The market index does not include the impact of the capital flows. Therefore, the TWR is a better measure to compare with indexes. The details of the difference from a computational standpoint are shown below:

Internal Rate of Return

Internal rate of return (also called money-weighted) is the discount rate on which the present value of inflows = present value of outflows. When applied to an investment portfolio:

Outflows

1. The cost of any investment purchased
2. Reinvested dividends or interest
3. Withdrawals

Inflows

1. The proceeds from any investment sold
2. Dividends or interest received
3. Contributions

Example:

Each inflow or outflow must be discounted back to the present using a rate (r) that will make PV (inflows) = PV (outflows). For example, take a case where we buy one share of a stock for \$50 that pays an annual \$2 dividend, and sell it after two years for \$65. Our money-weighted rate of return will be a rate that satisfies the following equation:

$$\text{PV Outflows} = \text{PV Inflows} = \$2/(1+r) + \$2/(1+r)^2 + \$65/(1+r)^2 = \$50$$

Solving for r using a spreadsheet or financial calculator, we have a money-weighted rate of return = 17.78%.

It's important to understand the main limitation of the money-weighted return as a tool for evaluating managers. As defined earlier, the internal rate of return factors all cash flows, including contributions and withdrawals. Let's assume that an internal rate of return is calculated over many periods; the formula will tend to place a greater weight on the performance in periods when the account size is highest (hence the alternate label money-weighted).

In practice, if a manager's best years occur when an account is small, and then (after the client deposits more funds) market conditions become more unfavorable, the money-weighted measure doesn't treat the manager fairly. Let's look at the situation another way: assume that the account has annual withdrawals to provide a retiree with income, and the manager does relatively poorly in the early years (when the account is larger), but improves in later periods after distributions have reduced the account's size. Should the manager be penalized for something beyond his or her control? Deposits and withdrawals are usually outside of a manager's control; thus, a better performance measurement tool is needed to judge a manager more fairly and allow for comparisons with peers - a measurement tool that will identify and measure the investment actions, and not evaluate the account based on deposit/withdrawal activity.

Time-Weighted Rate of Return

The time-weighted rate of return is the preferred industry standard because it is not sensitive to the account holder's contributions or withdrawals. TWR is defined as the compounded growth rate of \$1 over the period being measured. The time-weighted formula is essentially a geometric mean of a number of holding-period returns that are linked together or compounded over time (thus, time-weighted). The holding-period return, or HPR, (rate of return for one period) is computed using this formula:

$$\text{HPR} = ((\text{MV}_1 - \text{MV}_0 + \text{D}_1 - \text{CF}_1) / \text{MV}_0)$$

Where: MV_0 = beginning market value, MV_1 = ending market value,
 D_1 = dividend/interest inflows, CF_1 = cash flow received at period end (deposits subtracted, withdrawals added back)

For time-weighted performance measurement, the total period to be measured is divided into many sub-periods, with a sub-period ending (and portfolio priced) on any day with significant contribution or withdrawal activity, or at the end of the month or quarter. Sub-periods can cover any length of time chosen by the manager and need not be uniform. A holding-period return is computed using the above formula for all sub-periods. Linking (or compounding) HPRs is done by:

- (a) adding 1 to each sub-period HPR, then
- (b) multiplying all $1 + \text{HPR}$ terms together, then
- (c) subtracting 1 from the product:

Compounded time-weighted rate of return, for N holding periods

$$= [(1 + \text{HPR}_1) * (1 + \text{HPR}_2) * (1 + \text{HPR}_3) \dots * (1 + \text{HPR}_N)] - 1.$$

The annualized rate of return takes the compounded time-weighted rate and standardizes it by computing a geometric average of the linked holding-period returns.

$$\text{Annualized rate of return} = (1 + \text{compounded rate})^{1/Y} - 1$$

Where: Y = total time in years

Example: Time-Weighted Portfolio Return

Consider the following example: A portfolio was priced at the following values for the quarter-end dates indicated:

Date	Market Value
Dec. 31, 2003	\$200,000
March 31, 2004	\$196,500
June 30, 2004	\$200,000
Sept. 30, 2004	\$243,000
Dec. 31, 2004	\$250,000

On Dec. 31, 2004, the annual fee of \$2,000 was deducted from the account. On July 30, 2004, the annual contribution of \$20,000 was received, which boosted the account value to \$222,000 on July 30. How would we calculate a time-weighted rate of return for 2004?

Answer:

For this example, the year is broken into four holding-period returns to be calculated for each quarter. Also, since a significant contribution of \$20,000 was received intra-period, we will need to calculate two holding-period returns for the third quarter, June 30, 2004, to July 30, 2004, and July 30, 2004, to Sept 30, 2004. In total, there are five HPRs that must be computed using the formula $\text{HPR} = (\text{MV}_1 - \text{MV}_0 + D_1 - \text{CF}_1) / \text{MV}_0$. Please note that, since D_1 , or dividend payments, are already factored into the ending-period value, this term will not be needed for the computation. On a test problem, if dividends or interest is shown separately, simply add it to ending-period value. The calculations are done below (dollar amounts in thousands):

Period 1 (Dec 31, 2003, to Mar 31, 2004):

$$\text{HPR} = ((\$196.5 - \$200) / \$200) = (-3.5) / 200 = -1.75\%.$$

Period 2 (Mar 31, 2004, to June 30, 2004):

$$\text{HPR} = ((\$200 - \$196.5) / \$196.5) = 3.5 / 196.5 = +1.78\%.$$

Period 3 (June 30, 2004, to July 30, 2004):

$$\text{HPR} = ((\$222 - \$20) - \$200) / \$200 = 2 / 200 = +1.00\%.$$

Period 4 (July 30, 2004, to Sept 30, 2004):

$$\text{HPR} = (\$243 - \$222)/\$222 = 21/222 = +9.46\%$$

Period 5 (Sept 30, 2004, to Dec 31, 2004):

$$\text{HPR} = ((\$250 - \$2) - \$243)/\$243 = 5/243 = +2.06\%$$

Now we link the five periods together, by adding 1 to each HPR, multiplying all terms, and subtracting 1 from the product, to find the compounded time-weighted rate of return:

$$\begin{aligned} \text{2004 return} &= ((1 + (-.0175))*(1 + 0.0178)*(1 + 0.01)*(1 + 0.0946)*(1 + 0.0206)) - 1 = \\ &((0.9825)*(1.0178)*(1.01)*(1.0946)*(1.0206)) - 1 = (1.128288) - 1 = 0.128288, \text{ or } 12.83\% \text{ (rounding to} \\ &\text{the nearest } 1/100 \text{ of a percent).} \end{aligned}$$

Annualizing: Because our compounded calculation was for one year, the annualized figure is the same +12.83%. If the same portfolio had a 2003 return of 20%, the two-year compounded number would be $((1 + 0.20)*(1 + 0.1283)) - 1$, or 35.40%. Annualize by adding 1, and then taking to the 1/Y power, and then subtracting 1: $(1 + 0.3540)^{1/2} - 1 = 16.36\%$.

Convertible Bonds

Every one of our models includes convertible bonds as an asset class. Due to their nature we consider them part of the growth asset portion of a portfolio and not as fixed income. Convertible bonds are issued by a company which does not have the easy access to credit markets as a larger firm does and thus it needs to add a “kicker” or “sweetener” to the bond to gain access to cheaper money and lower its interest costs. The “kicker” is the option or warrant that is attached to the bond. The option allows the holder of the bond to convert it into the stock of the issuer. Convertible bonds are therefore a hybrid security that has some of the best attributes of both bonds and stock. Consider the following example:

A firm issues a convertible bond for \$1,000 with a coupon rate of 3% and a conversion ratio of 25.

Here are some key concepts that determine the price performance of the bond:

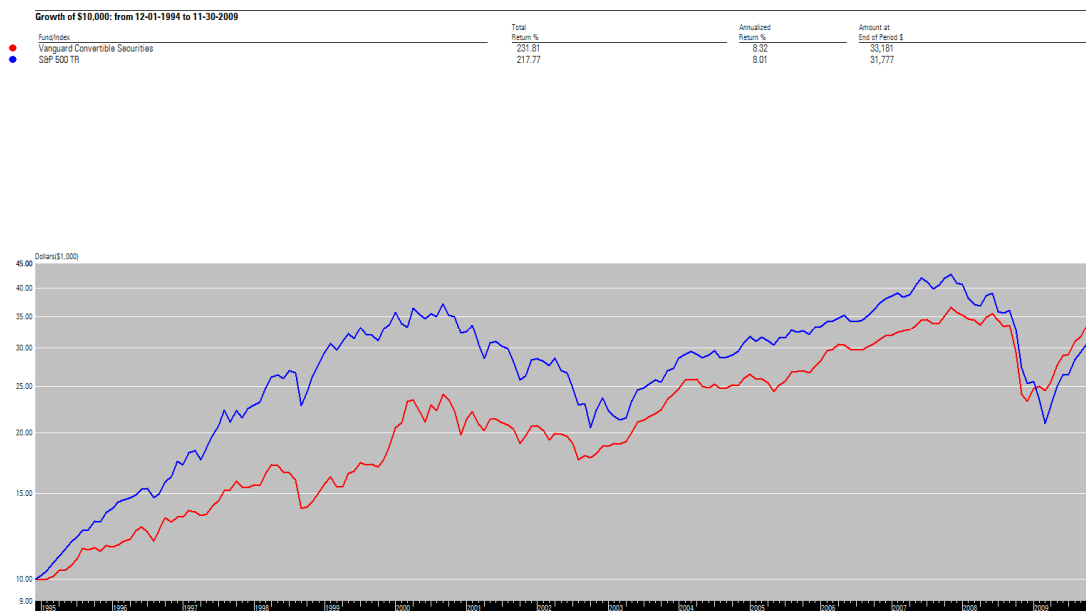
Conversion Ratio: Before the bond may be issued, the issuer establishes the number of shares of the underlying stock the bond may be converted to. For example a conversion ratio of 25 means the bond can be traded back to the issuing party, and the bond’s owner will receive 25 shares of the firm’s common stock in return for the bond.

It is important to understand that the conversion ratio sets the effective price the bond owner is paying for the stock. In the example above with the ratio of 25, the bond owner is effectively paying \$40.00 per share for the stock ($\$1,000/25=\40). If the stock is currently valued at only \$20.00 per share, the bondholder will not find it profitable to convert the bond, since he/she will be trading a \$1,000 bond for $\$20 * 25 = \500 worth of stock. Once the price of the stock rises above 40, the bond’s price begins to mirror the price of the underlying stock and it will be more “equity” like.

Coupon Rate: The coupon rate is the amount of interest the holder of the bond receives every 6 months. If the coupon on the \$1,000 bond is 3% it means the bondholder receives \$15 every six months. This is important: if the underlying stock is below \$40 per share, the bond’s price is more sensitive to interest

rates and the current rate on bonds with a similar credit rating. This provides a “floor” for the value of the position if the stock drops in price before conversion.

In short, convertibles act like a stock in a good market and a bond in a bad market. We have always liked the return vs. risk for these securities. The graph below shows the performance on the Vanguard Convertible Bond Fund vs. the S&P 500 since 1994.



The return is similar to equity returns but the risk is less.

We’ve provided you with general news and views and with insights on some complex technical concepts. Please give us your feedback on the contents of this newsletter. Let us know your thoughts about what you’d like to see in the newsletter. Our email addresses are below. Feel free to contact any one of us.

In the meantime, all of us at Stonegate Wealth Management hope you had a very happy holiday season and that you have a prosperous 2010.

Items of Note

We will be sending you reports to facilitate your tax preparation in a week or two. The reports will include capital gains and losses and investment expenses.

Cary and **Mike** will be speaking about “Money Management and Investment Tips for Young Women” as part of a presentation titled Do It Herself- A Journey to Financial Freedom at Seton Hall University in South Orange on Saturday January 23rd 2010. The event is being promoted by the New Jersey Society of Certified Public Accountants.

Several members of Stonegate received their AIF designation including **Steven (Little)**, **Chuck** and **Michael (Keane.)**

Stephen (Craffen), (NAPFA Eastern/Mid-Atlantic Region Study Group Director) in conjunction with two other members of NAPFA's Eastern Regional Board has organized a Symposium for members of the profession to be held at the Newark Gateway Hilton on January 20th. The topics covered are advancements to modern portfolio theory, investment manager selection, and behavioral finance.

Kim completed all 5 courses for the CFP designation; she expects to take the comprehensive exam in July.

Regards,

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