

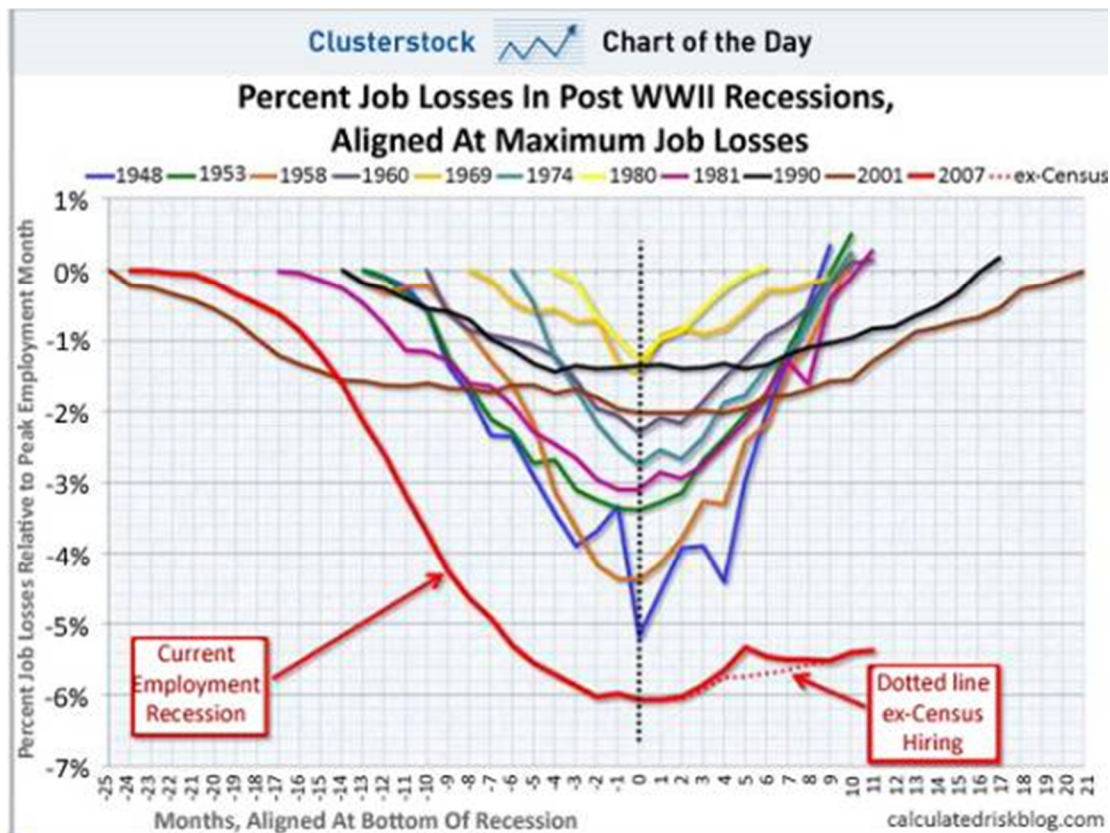
December 21, 2010

*Dear Client,*

In this edition of our newsletter we discuss current economic conditions; the software project we are involved in, and the extension of the current tax rates that was signed into law.

### The Economy

The economy is still lacking significant improvement. At this point, we are experiencing one of the poorest recoveries in employment after a recession since at least the 1940's.



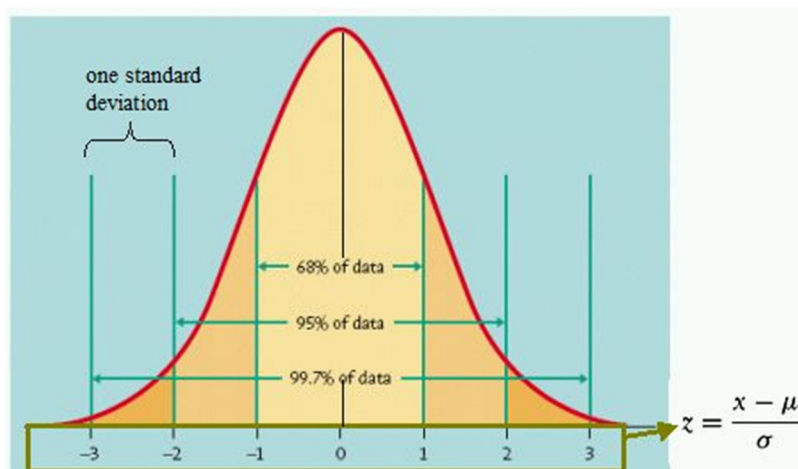
Most economists seem to agree that the fiscal stimulus plan passed in early 2009 did little to ameliorate unemployment and increase economic activity in a fashion that will spur long-term improvement. Consumer spending represents 70% of economic activity, so with at least 10% of the working force unemployed it is doubtful that the economy can dramatically improve until that rate drops. It may take some time, since some economists believe the real figure is closer to 17% as some people who are currently unemployed are not reported on the rolls. They have

become so disheartened that they are no longer actively seeking employment. We believe the recent passage of an extension of current tax rates will provide a boost since individuals and businesses now have more certainty. Factoring in a 2% temporary cut in the payroll tax, many economists are predicting 0.5% - 1.0% higher growth in 2011. Many economists had suggested that a cut in the payroll tax would have had a more stimulating effect on the economy than the wasteful package Congress passed 2 years ago. We're glad to see that the idea has finally (belatedly) broken through. Next Congress needs to tackle the enormous deficit which is a significant danger to the future of this country. Tax increases are not the way to tackle it though as spending has increased to nearly 25% of GDP from its average rate (over the last 40-50 years) of 18-20%. Any increase in taxes that increases the Federal Government's "take" from the private sector will most likely result in reduced growth and wealth generation.

### Revising Asset Allocation Theory

In our last newsletter, we briefly mentioned our involvement in a software project with another firm, who shall remain nameless as we'd like to preserve their privacy. All we can say is that they are a well known firm here in the Northeast, and that they are roughly double our size. This project may be considered by some to be groundbreaking work. Its purpose is to attempt to revise the statistical simplifications which were made to Modern Portfolio Theory (MPT). These simplifications greatly hinder its effectiveness and tend to make it a somewhat poor model for real world events. In the next paragraph, we'll touch base on the history of MPT and briefly explain its simplifications and limitations.

Modern portfolio theory was devised by Dr. Harry Markowitz in the 1950's; he won a Nobel Prize for the theory in 1990 (together with William F. Sharpe and Merton H. Miller). Dr. Markowitz was the first one to apply statistical techniques to quantifying the risk of investing. He assumed that the return on an investment in any given year is a random amount with the occurrences of particular values distributed according to a normal distribution:



The peak of the distribution is the average investment return for the investment and 95% of all occurrences occur within 2 standard deviations of the average. The S&P 500 as an example has an average return of approximately 10% but a variability (standard deviation) of 18% therefore most actual, annual returns lie between -34% and + 46%.

A second important development is how Dr. Markowitz characterized the interrelationship between asset class returns. He used a statistical concept called correlation. We won't bore you with the mathematics of it, but a couple of examples make it easy to understand. If two assets are perfectly correlated, i.e. they move in sync, then their correlation equals 1; if they move in opposite directions then the correlation is -1. If they move partially together or partially in an opposite fashion then the correlation ranges between 1 and -1.

The third important development was how Dr. Markowitz used the mathematical constructs to devise what he called "efficient" portfolios. He used the statistics to combine assets whose correlations indicated they did not move in sync to create combinations that had lower risk than the individual asset classes themselves. He showed mathematically that for any given desired return you could combine different assets such that the risk of the portfolio had a minimum amount making the portfolio "efficient."

Dr. Markowitz revolutionized the construction of portfolios, for the first time portfolio managers had a logical process rooted in mathematics that enabled them to quantify risk and also design portfolios. His approach to solving for efficient combinations of assets worked well with the computer power that became available in the 1960's and 1970's.

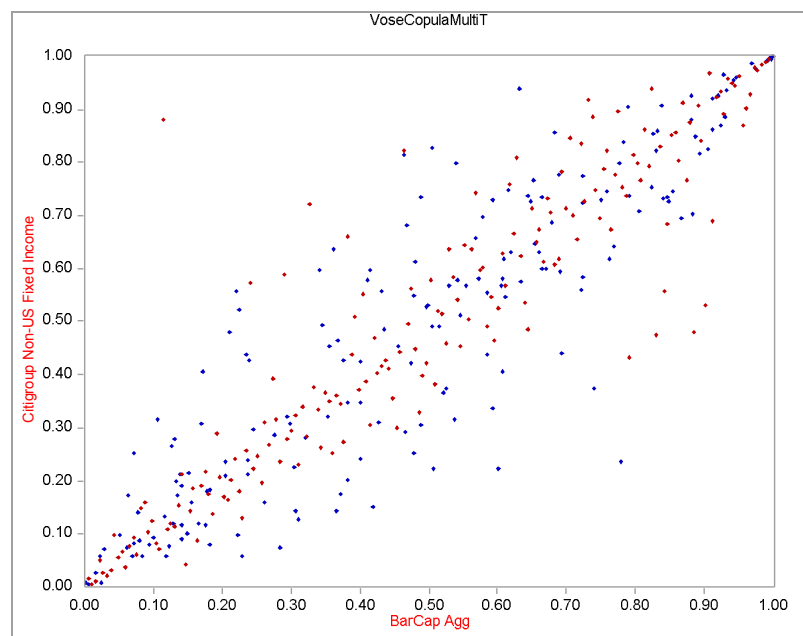
Unfortunately his techniques made many (necessary at that time) simplifying assumptions that have lessened its utility:

1. Random investment returns could be modeled using a normal distribution—experience has shown that extreme events and the commensurate extreme returns experienced during them is much more likely than the normal distribution model indicates.
2. That the complex interrelationship of investment returns could be modeled using a single number (correlation). We know that is not true—what happened in the market during 2008 shows us that. Nearly every asset class became correlated to one another, something that typically happens frequently when bad events occur. This is a key weakness of MPT.
3. Volatility is constant and not related to volatility in the prior period—we know this is not true! Anyone who watches the VIX index knows that volatility occurs in streaks (clustering) and that it can be related to the volatility for a prior period.
4. Single period approach—His approach uses arithmetic rates of return not geometric. As we discussed in a prior newsletter, volatility increases the difference between the average and geometric rate of return. As investors, we only care about the one that affects our wealth: geometric (compounded) rate of return.
5. No rebalancing—we know rebalancing can dramatically improve investment outcomes. In fact rebalanced portfolios can achieve a higher rate of return than the return of their components. MPT does not incorporate it.

Unfortunately, there is no “out of the box” software package readily available on the market that offers a solution to these issues. We were approached by another firm to take part in a software project with an outside consultant to create software we could both use to eliminate most of these constraints and enable us to create allocation models that more closely reflect real world behavior of asset classes. This project is nearly complete. We are now in the beginning of a lengthy process which we feel will greatly improve our portfolio management process to deliver additional value to your portfolio as a client:

### Software Description:

- It has the ability to choose the best probability distribution that fits the return series for an asset class. If we use 30 different asset classes, we could conceivably fit a different distribution to each that more closely models the risk profile of the asset.
- It can model volatility clustering.
- The complex relationship (correlation) between asset classes can be modeled as a formula rather than a single number. Therefore events that cause investments to move together are properly modeled and factored into our asset allocations. The term to describe this is a “copula.” One is illustrated below:



The figure above illustrates the complex relationship between the return on foreign and domestic bonds.

- Both geometric returns and various rebalancing strategies can be modeled and evaluated.
- Combinations of assets will eventually be devised that will be better able to withstand extreme events like the markets fall in 2008.

We expect the efficient frontier to look very different when this new methodology is completely implemented in our systems. This is a huge advance in the methodology behind asset allocation theory and we'll be discussing this further in future newsletters.

### **The President Signs the 2010 Tax Relief Act into Law**

We were pleased to see that an extension of the current tax rates for the next 2 years passed and was signed by the president. Highlights of the tax law follow.

#### **Reductions in Individual Income Tax Rates through 2012**

- Income brackets remain 10, 25, 28, 33, and 35 percent
- Capital gains and dividend rates remain at 0 or 15 percent
- Repeal of the Personal Exemption Phase-out (PEP)
- Repeal of the itemized deduction limitation (Pease limitation)
- Marriage penalty relief
- Expanded dependent care credit
- Child Tax Credit
- Earned income tax credit

#### **Education Incentives Extended Through 2012**

- Expanded Coverdell accounts and definition of education expenses
- Expanded exclusion for employer-provided educational assistance of up to \$5,250
- Expanded student loan interest deduction
- Exclusion from income of amounts received under certain scholarship programs
- American Opportunity Tax Credit of up to \$2,500 for tuition expenses

#### **Extension of Certain Expiring Provision for Individuals through 2011**

- Above-the-line deduction for qualified tuition and related expenses
- Tax-free distributions of up to \$100,000 from individual retirement plans for charitable purposes. Donors may treat donations made in January 2001 as if made in 2010.
- 30-percent credit for energy-efficiency improvements to the home (IRC section 25C)
- Deduction of state and local general sales taxes
- Parity for employer-provided mass transit benefits
- Contributions of capital gain real property for conservation purposes
- Deductibility of mortgage insurance premiums for qualified residence
- Estate tax look-through of certain Regulated Investment Company (RIC) stock held by nonresidents for decedents dying before January 1, 2012
- Above-the-line deduction for certain expenses of elementary and secondary school teachers

### Alternative Minimum Tax (AMT) Relief

- The legislation increases the exemption amounts for 2010 to \$47,450 (individuals) and \$72,450 (married filing jointly) and for 2011 to \$48,450 (individuals) and \$74,450 (married filing jointly). It also allows the nonrefundable personal credits against the AMT.

### Temporary Estate Tax Relief and Modification of Gift and Generation-skipping Transfer Taxes

- **Higher exemption, lower rate.** The legislation sets the exemption at \$5 million per person and \$10 million per couple and a top tax rate of 35 percent for the estate, gift, and generation skipping transfer taxes for two years, through 2012. The exemption amount is indexed beginning in 2012. The proposal is effective January 1, 2010, but allows an election to choose no estate tax and modified carryover basis for estates arising on or after January 1, 2010 and before January 1, 2011. The proposal sets a \$5 million generation-skipping transfer tax exemption and zero percent rate for the 2010 year.
- **Portability of unused exemption.** Under current law, couples have to do complicated estate planning to claim their entire exemption. The proposal allows the executor of a deceased spouse's estate to transfer any unused exemption to the surviving spouse without such planning. The proposal is effective for estates of decedents dying after December 31, 2010.
- **Reunification of estate and gift taxes.** Prior to the 2001 tax cuts, the estate and gift taxes were unified, creating a single graduated rate schedule for both. That single lifetime exemption could be used for gifts and/or bequests. The proposal reunifies the estate and gift taxes. The proposal is effective for gifts made after December 31, 2010.
- As noted above, the look-through of RIC stock held by non-resident decedents is extended through 2011

### Temporary Extension of Investment Incentives

- **Extension of bonus depreciation for taxable years 2011 and 2012**
- **Small Business Expensing: increase in the maximum amount and phase-out threshold under section 179.** Sets the maximum amount and phase-out threshold for taxable years 2012 at \$125,000 and \$500,000 respectively, indexed for inflation. (Previously-passed legislation raised the 2010 and 2011 max amount and phase-out at \$500,000 and \$2,000,000 respectively.)

### Extension of Certain Expiring Provisions for Businesses through 2011

- Enhanced charitable deduction for corporate contributions of computer equipment for educational purposes
- Enhanced charitable deduction for contributions of food inventory
- Enhanced charitable deduction for contributions of book inventories to public schools
- Special rule for S corporations making charitable contributions of property
- 15-year straight-line cost recovery for qualified leasehold improvements
- Employer wage credit for activated military reservists

- Tax benefits for certain real estate developments
- Extension of expensing of environmental remediation costs
- Treatment of interest-related dividends and short term capital gain dividends of Regulated Investment Companies (RICs)
- Work opportunity tax credit (WOTC)
- 100% Exclusion of qualified small business capital gains held for more than 5 years (IRC§1202)
- Research credit
- Qualified Zone Academy bonds

#### Extension of Unemployment Insurance

- The unemployment insurance proposal provides a one-year reauthorization of federal UI benefits.

#### Temporary Employee Payroll Tax Cut

- The legislation creates a payroll/self-employment tax holiday during 2011 of two percentage points. The employer's share of the payroll tax remains unchanged. This means employees will pay only 4.2 percent on wages and self-employed individuals will pay only 10.4 percent on self-employment income up to \$106,800. The social security trust fund is made whole by transfers from the general fund.

#### Some Year End Points

There is so much to do with the end of year upon us and the busy holiday season. Here are some end of year reminders of things to consider or note.

- Decide to Roth or not, you only have until 12/31/10 if you want to spread taxes over 2011 and 2012.
- Take Your RMD, if you are over 70 ½ you have to take your distribution before year end
- Book Tax Losses before 12/31/10.
- Use your Flexible Savings Account- Use it or lose it.
- Max Out your Retirement Account, all 401k, 403B etc, IRA's you have until April 15 2011 to fund 2010.
- Make Charitable Contributions.
- Fund Health Care Saving Account- This is if you have an HSA high deductible plan you can put away additional money that is tax deductible that grows tax free for health care.
- Make Gifts, you can give \$13,000 per person per year this is a way to gift money out of your estate without the gift tax

## **Stonegate News**

Cary has been quoted extensively in the media over the last few months:

**Cary is Quoted in the Wall Street Journal (December 13th, 2010)**

**Title:** *Just Say No. Please.* by Veronica Dagher

**Description:** Financial advisers sometimes have to talk their clients out of really bad ideas. Cary shares her experience with saving a client from making a big investment mistake.

**Quote:** "When a client wanted to invest in a company called Agape because a friend had doubled his money with such an investment, Cary Carbonaro, a Fair Lawn, N.J., certified financial planner, was skeptical. As soon as she read the investment proposal, she says, she knew Agape was a fraud. 'The proposal had a chart showing growth of cash at 3%, growth of bonds at 6%, growth of stock at 9% and growth of Agape at 100%—with no risk,' she says. She told her client she thought Agape was a pyramid scheme and advised him not to invest.

The client took her advice. A few months later, in April 2009, the owner and president of Agape World Inc. and Agape Merchant Advance LLC, Nicholas Cosmo, was indicted on charges of mail and wire fraud. Ms. Carbonaro called the client the same day. 'They were crying and thanking me,' she says.

Mr. Cosmo pleaded guilty to mail and wire fraud in October in U.S. District Court in Central Islip, N.Y. Federal prosecutors said he bilked investors out of about \$195 million. He is scheduled for sentencing in February. Mr. Cosmo's lawyer declined to comment."

You may view other quotes as follows:

- **December 5th, 2010 - Cary is Quoted in the Orlando Sentinel**  
[http://www.stonegatewealth.com/2010\\_12\\_05\\_Orlando%20Sentinel\\_AskanExpert\\_Carbonaro.pdf](http://www.stonegatewealth.com/2010_12_05_Orlando%20Sentinel_AskanExpert_Carbonaro.pdf)
- **November 21st, 2010 - Cary is Quoted in the Orlando Sentinel**  
[http://www.stonegatewealth.com/2010\\_11\\_21\\_Orlando%20Sentinel\\_AskanExpert\\_Carbonaro.pdf](http://www.stonegatewealth.com/2010_11_21_Orlando%20Sentinel_AskanExpert_Carbonaro.pdf)
- **October 23th, 2010 - Cary is Quoted in the Orlando Sentinel**  
[http://www.stonegatewealth.com/2010\\_10\\_23\\_OS%20Ask%20an%20Expert\\_Carbonaro.pdf](http://www.stonegatewealth.com/2010_10_23_OS%20Ask%20an%20Expert_Carbonaro.pdf)
- **October 17th, 2010 - Cary is Quoted in the Orlando Sentinel**  
[http://www.stonegatewealth.com/2010\\_10\\_17\\_OS\\_Ask%20an%20Expert\\_Carbonaro](http://www.stonegatewealth.com/2010_10_17_OS_Ask%20an%20Expert_Carbonaro)

**Kim Viscuso** received her Chartered Retirement Plan Specialist (CRPS<sup>SM</sup>) designation.

**Alison** received her Registered Paraplanner (RP<sup>SM</sup>) designation.

**Stephen Craffen** spoke at the NAPFA regional conference in Boston in early November, the topic was technology.

As always please call us with any questions.

***Regards,***

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