***September 16, 2009***

***Dear Client***,

We hope you are well. This has been quite a strange summer so far hasn't it? We experienced one of the rainiest and coolest June's since 1958 and so far for July the temperature has not exceeded 90 degrees. We hope you are enjoying the summer despite all that.

**Asset Class Performance**

This year is dramatically different from last year with many asset classes are performing well. For the last few months of 2008 nearly every asset class experienced losses save for a few (it seems that one of those supposed infrequent events which seem to occur with alarming frequency occurred). Everything became correlated and went down nearly the same amount; 35-40%. So far this year the correlation has broken down and several if not most asset categories are up by varying amounts with one exception -- domestic real estate which is negative for 2009. The performance of some key assets is shown below: (Please note the performance figures are samples of the returns for funds you hold and are not the returns of indices).

| Asset Class | 2009 Performance (Through 6/30/2009) |
|---|---|
| Convertible Bonds | 17% (Vanguard Convertible Fund) |
| Natural Resources | 14.5% (PIMCO Commodity Real Return) |
| International Real Estate | 12.5% (C&S International Realty) |
| Domestic Real Estate | -10.5% (C&S Realty Shares) |
| Large Cap Stocks | 2-12% (Depends on fund) |
| Mid Cap Stocks | 8-16% (Westport and Fairholme) |
| Market Neutral | 3.7-8.4% (C&O and TFS0 |

**Alternative Investments**

In the new allocations adopted this year we greatly increased our commitment to alternative asset classes (from an average of 2-5% to 10%), this category is represented through an investment strategy known as long/short (L/S) and market neutral (M/N). Those strategies are very similar in nature and have both been used by hedge funds since the 1940's. While many of the strategies used by hedge funds make sense we avoid them because we just don't like the vehicle with their excessive fees, lockup periods, lack of transparency, etc. As more of these strategies for example, convertible arbitrage or merger arbitrage become available through either ETF's or mutual funds we will complement the L/S strategy with them.

The commitment to L/S is higher for two reasons, first more data is available that increased our confidence that these strategies can add diversification value to portfolios through their seeming lack of correlation to the stock market, and secondly because as they become more widely available through mutual funds more choices exist. After reviewing the performance of many of these funds it was concluded that two, TFS Capital Market Neutral and Caldwell & Orkin Market Neutral had performance

that warranted inclusion in your portfolio. Their performance in 2008 was impressive, TFS was down only 7.2% and Caldwell & Orkin was down 4.6% while large cap stocks dropped 37%. We did own TFS for most of last year when our initial allocation to market neutral began but Caldwell and Orkin is new this year as a replacement for Diamond Hill.

***So how does Market Neutral or Long/Short Work?***

Managers of stock portfolios filter through the 8,000+ listed stocks to see which ones represent the shares of companies that will provide good returns in the future. They evaluate many factors and will closely examine the company's balance sheet and possibly meet with their management. In analyzing the universe of available opportunities they will also uncover prospects whose future looks particularly bad; either because the company is strong but the stock is overpriced, or the company is weak but the stock price does not yet reflect that weakness. Most managers then ignore the poor opportunities and only invest in the good ones – effectively discarding half their work. Managers of L/S and M/N funds do not do that. They purchase the stocks of companies with favorable prospects and sell the stocks that they think will go down in value short. Selling short means selling stock you do not own by borrowing the shares from someone else. Brokerage firms arrange the loan of shares. If the stock price decreases as expected the borrowed shares are replaced by purchasing shares that now cost less. The stock that was borrowed and sold for $50/share is repaid by purchasing shares that now cost $40/share; earning $10/share. The total return on a market neutral or long short strategy is composed of two pieces:

- The return on the cash component: When you sell stock short you generate cash which may be invested in a money market fund
- The return on the equity component which is the difference in the return between the long positions and the short positions. This return has almost no correlation to the market if the manager carefully selects the stocks to eliminate most systematic risk. The return on the equity component is almost all manager "alpha" or the return based on the managers stock selection abilities and not the correlation of the stock to the market.

Here is an example of how this works if the market rises:

If the market rises and the manager's long position increases 30% their short positions might also rise forcing them to repurchase shares at a higher price than they sold them, causing a 27% loss on the short positions. The net return from the equity components would therefore be 30% -27% = 3%. The cash from the sale of the short positions was invested in a money market fund that earned 3% for the year. The total return for the fund is 3% + 3% = 6%

This is how it works if the market declines:

If the market declines and the long positions decrease in value by 25% with the short positions also declining, the managers can profit on the short positions by replacing the borrowed shares with (now) cheaper ones thus enabling them to record a profit of 35% on the shorts, with the net return for the equity component equaling: 35% - 27% = 8%. If the cash return is 3% then the total return for the fund is 11% even though the market dropped.

This example illustrates how the return from market neutral strategies can have such a low correlation with the stock market. Theoretically the long term return for market neutral should be somewhere between equity and bonds with volatility similar to bonds.

The performance for the two funds you own is shown below (through June 2009):

| Fund Name | Tot Ret 1 Mo | Tot Ret 12 Mo | Tot Ret YTD | Tot Ret Annlzd 3 |
|---|---|---|---|---|
| Caldwell & Orkin Market Opportunity | -2.55 | -0.88 | 3.69 | |
| TFS Market Neutral | 0.35 | -6.57 | 8.43 | |

***Managed Futures***

Eventually other strategies will be included in the Alternative's category. One candidate that might be in the near future is Managed Futures. Managed Futures is a variant of funds that invest in commodities futures but with a twist; the fund manager can either purchase long or sell short commodities futures contracts. The approach is similar to the long short strategies discussed before. Though few funds exist that implement the strategy it is of interest because Standard and Poor's has created an index called the Commodities Trends Indicator (CTI) that has been back tested to 1985 with results that are compelling; it has averaged 12.19% annually over the ten years ending December 2008 with much less volatility than the average commodities fund. In 2008 its return was 17% an impressive result considering the performance of most natural resources last year. Some key characteristics of this index are:

- It may provide equity-like returns over time;
- It typically exhibits a low correlation to stocks and bonds;
- It can potentially serve as an effective hedge against both inflation and deflation;
- It is a powerful diversification tool that may help to enhance overall performance in many portfolios;
- It provides exposure to inverse strategies in addition to traditional long-only strategies; and
- It may be an effective complement to other alternative investments.

The CTI consists of 16 commodity contracts including as a sample:

- Heating Oil
- Light Crude
- Copper
- Gold
- Corn
- Coffee
- Etc.

Long or short positions are determined by comparing the current commodity price to a moving average and commodity positions are rebalanced monthly or annually. The CTI index tends to mitigate the effect of commodity price bubbles and their cyclical nature. The CTI index has a very low correlation to other assets in our client's portfolios. This index is investable either through a fund offered by Direxion or through a new ETN created by S&P, the Elements S&P CTI ETN (Exchange Traded Note). We will be monitoring the performance of this asset class and may make a decision to incorporate it sometime later this year. Most likely the Direxion fund (DXTCX) will be used since ETN's have additional risk since they are issued by a counterparty (for example Barclay's) and are only as secure as the issuer.

***Our overriding goal for this category is to find investment strategies that do not move in conjunction with or are correlated to other pieces of your portfolio.***

**Social Security**

Should you take Social Security early or should you wait until age 70? Should you take Social Security at your normal retirement age or should you use a new strategy called "file and suspend?" Making the right decision and maximizing the value of Social Security to you is a difficult one since many variables need to be considered; your projected life expectancy, how much you can earn on your invested assets which are not used to support your lifestyle, the tax ramifications etc. You may have heard it said that you have to live to anywhere from 80-87 for it to make sense delaying Social Security to age 70. Of late our view on this matter has changed and we now see the value of delaying Social Security for as long as possible (70). Social Security has undergone significant changes that make the value of delaying the receipt of Social Security benefits greater than in the past. Specifically, the increase in the Full Retirement Age and Delayed Retirement Credits can result in significantly greater benefits from delaying Social Security and it now makes sense in many cases to delay it to 70. The increase in benefit payments at 70 vs. 66 is dramatic since the payment amount increases by roughly 8% for each year you delay. Thus the benefit at 70 can be 40% higher than the benefit at 66, that combined with the cost of living adjustments that are now based on a higher benefit amount can dramatically increase your payments over the remainder of your life. Social Security income is also taxed differently from other types of income including IRA withdrawals. Social Security is either 50% or 85% taxable once your income from nearly all sources including municipal bonds exceeds certain thresholds ($32,000 and $44,000 respectively for a married couple). IRA income is all taxed as ordinary income. If more of your income is Social Security income and less is IRA income your total tax bill can be less. That is shown in the example below.

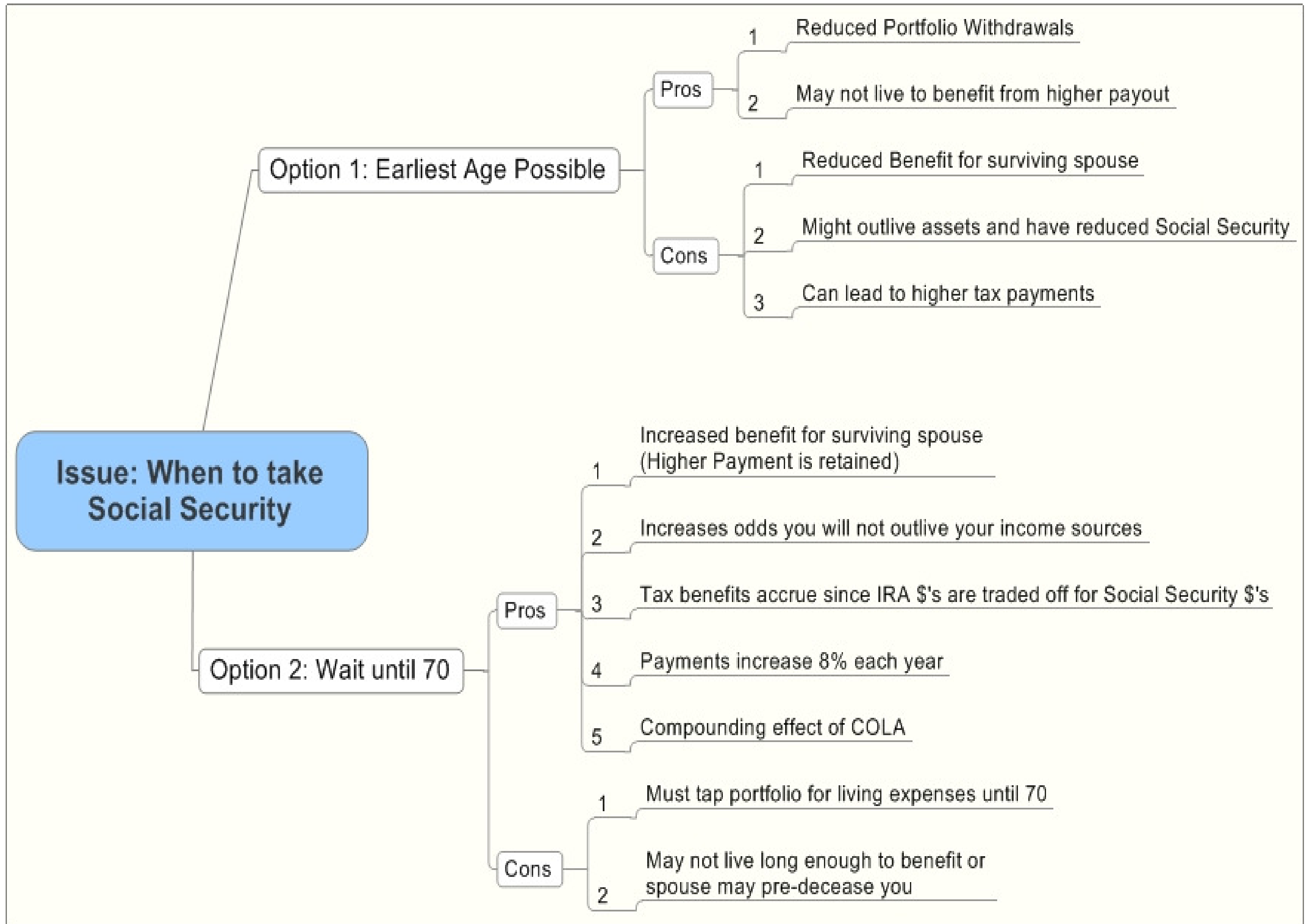
Comparison of Taking Higher Amount of Income in the Form of Social Security (Tax Year 2006)

| | *Strategy I* | *Strategy II* |
|---|---|---|
| Social Security Income | $24,000 | $39,000 |
| IRA yearly withdrawal | $45,000 | $30,000 |
| Other Taxable Income | $0 | $0 |
| Sum of Income from all sources | $69,000 | $69,000 |
| Combined Income | $57,000 | $69,000 |
| Income 50% Excess over 1st Threshold + 35% Excess over 2nd | $17,050 | $10,675 |
| 85% of Benefits | $20,400 | $33,150 |
| 50% of Benefits + 85% Excess over 2nd Threshold | $23,050 | $24,175 |
| Adjusted Gross Income (minimum of Combined Income Tests + IRA Income) | $62,050 | $40,675 |
| Federal Taxes | $6,060 | $2,854 |
| State Taxes | $2,891 | $1,895 |
| Other Non-Taxable Income | $0 | $0 |
| Total After-tax Income | $61,703 | $65,321 |

*Source*: Rethinking Social Security Claiming in a 401(k) World, James I. Mahaney and Peter C. Carlson, PRC WP 2007-18 Pension Research Council Working Paper, Pension Research Council, August 2007.

*Note:* This table indicates the tax efficiency of delaying Social Security once that higher income stream begins. The two columns compare taking the same amount of pre-tax income ($69,000) for a 72 year-old man with different amounts of Social Security and IRA income. The column on the right has a strategy that takes $15,000 more in Social Security income and $15,000 less in IRA income than the column on the left. As the right hand column indicates, Adjusted Gross Income is reduced by approximately one third compared to the left hand column because there is less IRA income and surprisingly, much lower taxable Social Security. State taxes are assumed to be 4.66%.

We created the "decision chart" shown below to help clarify the tradeoffs of taking Social Security early vs. delaying it to age 70. Consider this chart a work in progress since we will be adding other choices including taking Social Security at the earliest possible age, an option called "file and suspend," and one for taking the so-called "Social Security Loan." We will cover those options in future newsletters.




## **The Economy**

While there are some signs that provide glimmers of hope for an improving economy we fear that it may ultimately be a tepid recovery with a chance that a second recession may occur within the next 2-3 years. The huge deficits projected for the federal government and possible higher tax rates are a concern. (The demand for treasuries this week was tepid adding to the worry that the Fed's are borrowing too much) Huge deficits can lead to higher interest rates and higher inflation. Both can be damaging to the economy and can stifle economic growth leading to a return of the conditions we experienced in the late 70's.

Increasing tax rates of which there is much talk in Congress have typically also led to lower economic growth due to the drag, or friction taxes add to economic activity. If some of the tax increases being discussed pass, the residents of some states might be subject to marginal brackets that approach 60%. Ken Bagner CPA of Sobel and Co., one of the accounting firms we work with explained to us that someone earning from $100-150,000 who has children may be subject to a marginal bracket of nearly 60% when all the phase outs for tax credits, etc., are considered. That combined with some of the tax increases being proposed could lead to many people paying much more than half their income just in income taxes. This rate of taxation brings to mind how things were in the 1970's. In that decade we had inflation that ranged from 6-12% annually, low growth and federal marginal tax rates that were as high as 70% the economic term was Stagflation. (One significant difference is that state income tax rates are much higher now than they were then since the states are claiming a greater percentage of GDP.) Let's hope that we are not headed in that direction. One other cause for concern: most economists expect unemployment to keep rising since it has become a lagging indicator with companies slow to rehire workers until they are convinced that the economy is improving. Consumer spending represents 70% of economic activity so with roughly 1 out of 10 workers possibly unemployed there is a serious drag on economic growth.

**Stonegate News**

If you received this newsletter by mail it means we do not have a valid e-mail address for you. To save a few trees and speed up the delivery of important communications, please provide us with your current e-mail address or let us know if you prefer to receive these newsletters by mail.

***Mike Borowski CPA, CFP*** joined us on June 1. Mike has many years experience in the financial services field and most recently was at Merrill Lynch.

***Steve Craffen*** spoke before the Essex County CPA Society and discussed fiduciary standards as they relate to defined contribution plans and investment choices appropriate for the plans. We were asked to speak in conjunction with Ken Bagner CPA from the firm Sobel & Co.

***New Web Site***: We invite you to take a look at it and provide us with comments.

As always please call us with any questions.

***Regards,***


***Tom Geraghty*** ***tomg@stonegatewealth.com***
***Steve Craffen*** ***stevec@stonegatewealth.com***
***Craig Marson*** ***craigm@stonegatewealth.com***
***Peggy Braun*** ***peggyb@stonegatewealth.com***
***Kim Viscuso*** ***kimv@stonegatewealth.com***
***Mike Borowski*** ***mikeb@stonegatewealth.com***
***Marty Brown*** ***martyb@stonegatewealth.com***

***Stonegate Wealth Management, LLC***
***17-17 Route 208***
***Suite 250***

*Fair Lawn, NJ 07410*
*(201) 791-0085*
*(201) 625-6303 fax*

*www.stonegatewealth.com*