



August 26, 2010

Dear Client,

In this edition of our newsletter we discuss current economic conditions; a new fund we've begun to use called the Arbitrage Fund, and current interest rates.

The Economy

The economic recovery appears to be stalled. Jobless claims have been rising, new home starts are at their lowest level in 50 years and the stock market is moribund and trading in a range. Government policy has dramatically increased business and economic uncertainty and we fear we are seeing a repeat of the 1930's. Many economists now believe that FDR's policies in the 1930's prolonged the recession and it seems apparent that many of those policy mistakes are being repeated. While a double dip recession may be unlikely according to most economists, a very slow and lengthy recovery seems probable with unemployment dropping to full employment levels of 5% in maybe 4-5 years. Several key points:

- Corporations have 1.8T in cash on their balance sheets that is not being invested.
- Jobs are not being created fast enough to account for the increase in labor force each month.
- The federal deficit is at levels that are unsustainable.
- Unless Congress acts tax rates are going to increase substantially on January 1. The top bracket will increase from 35% to 39.6% and the capital gains rate will increase from 15% to 20%. Taking more money from the public to support Congress's profligate spending is not a way to stimulate economic growth.
- Sales of existing homes have reached a 15 year low. It will take 12 months to absorb the present supply of homes.
- New legislation including the health care bill are dramatically increasing uncertainty on the part of business's for future costs.

The market may not show strong direction for some time. As such we are continuing to make or contemplate adjustments to your portfolios:

- Additional alternative investment strategies are being considered or added including funds that use hedge fund strategies like convertible arbitrage and managed futures. These strategies can do well in markets that show no direction and also can help insulate them from volatility.
- A new asset class based on volatility and the VIX index is being studied (more on that later).
- We are analyzing all our models again.

- Trades that capture tax losses will be made where appropriate.
- Manager changes will be considered carefully if they generate large tax events.
- Changes we are considering may be accelerated to occur in 2010 to take advantage of the lower capital gains rate this year.
- A bubble may be forming in the bond market - we are continuing to keep our bond maturities short.

Alternative Assets - Focus on a Fund: The Arbitrage Fund

Over the last 2 years we have made major changes to our model allocations. We've covered the rationale behind that in past newsletters. Part of the rationale has been the recent availability of hedge fund like investment strategies through mutual funds and exchange traded funds. A substantial universe of funds and strategies have become available with many more on the way. As a result, the category "Alternative Assets" was added to all our models with an average allocation of 10%. One fund that has been added to the category this year is the Arbitrage Fund. This fund utilizes a strategy called merger arbitrage. Merger Arbitrage is a hedged strategy in which the fund invests in a portfolio of stocks involved in merger situations. The fund profits by earning the difference between the share price at which a target company trades at today and the consideration to be received by the target's shareholders on deal closure. That difference or "spread" is the primary driver of returns for this investment strategy. Here is an example (cash deal):

- Company A offers \$11.50 cash for Company B
- Company B is currently trading at \$11.00

$$\begin{array}{r}
 \$11.50 \quad \text{target price when deal closes} \\
 - \$11.00 \quad \text{target price today} \\
 \hline
 \$0.50 \quad \text{spread}
 \end{array}$$

- To calculate the percentage return in this merger arbitrage situation, divide the spread by the target's current price.

$$\frac{\text{spread}}{\text{(current price)}} = \$ \frac{0.50}{\$11.00} = 4.5\% \text{ return}$$

- To determine the annualized return on this deal, multiply by a factor equal to the time the deal will take to close. For purposes of this example, assume the deal takes six months to complete.

$$\frac{1 \text{ year}}{\text{time to close}} = \frac{12 \text{ months}}{6 \text{ months}} = 2$$

$$2 * 4.5\% = 9.5\% \text{ annualized return}$$

Here is a second example, a stock deal:

Actionable steps for the arbitrageur:

- Purchase 1 share of Company B today
- Sell short 1 share of Company A today

Here are the steps:

- Company A offers 1 share of Company A as the purchase price for 1 share of Company B
- Company A is currently trading at \$ 11.50
- Company B is currently trading at \$11.50

$$\begin{array}{r} \$11.50 \quad \text{acquirer price today} \\ - \$11.00 \quad \text{target price today} \\ \hline \$0.50 \quad \text{spread} \end{array}$$

- To calculate the percentage return in this merger arbitrage situation, divide the spread by the target's current price;

$$\frac{\text{spread}}{\text{current price}} = \frac{\$0.50}{\$11.00} = 4.5\% \text{ return}$$

- To determine the annualized return on this deal, multiply by a factor to the time the deal will take to close. For this example, let's assume the deal takes six months to complete:

$$\frac{1 \text{ year}}{\text{time to close}} = \frac{12 \text{ months}}{6 \text{ months}} = 2$$

- $2 * 4.5\% = 9\%$ annualized return

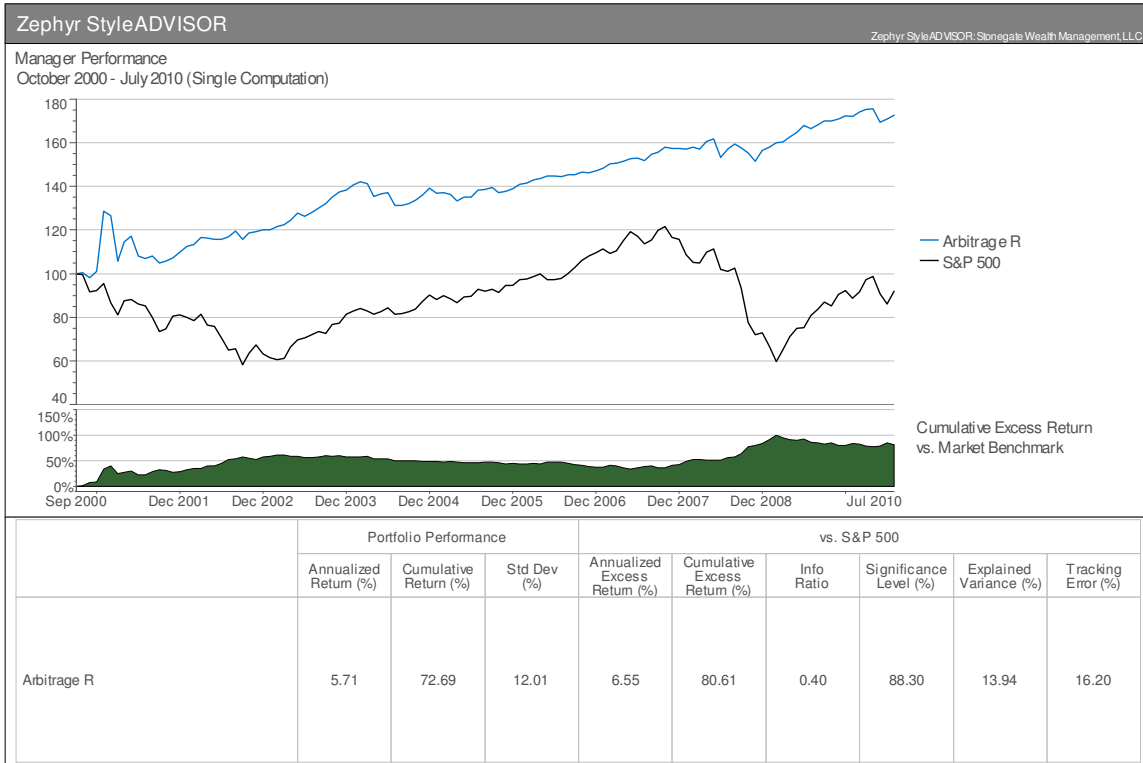
Here is the rationale behind this:

- By purchasing Company B at \$11.00, they are positioning themselves to receive 1 share of Company A when the deal closes.
- By selling short Company A at \$11.50, they are locking in today's price for tomorrow's delivery when the deal closes. The difference between the price of company A and Company B today is the spread they will capture should the deal reach a successful conclusion.
- By selling Company A short, they are protecting against a future drop in Company A's share price while locking in tomorrow's price of delivery today.
- They are not selling Company A short since they think it will go down in value, but rather selling Company A short to protect their defined spread against the possibility of Company A declining in value. They do not want to receive delivery of Company A in

exchange for Company B when the deal closes, only to find that Company is trading at \$9.00 a share or less.

- This shows why merger arbitrage has definable projected rates of return and may be defined as “long/short with a purpose.”

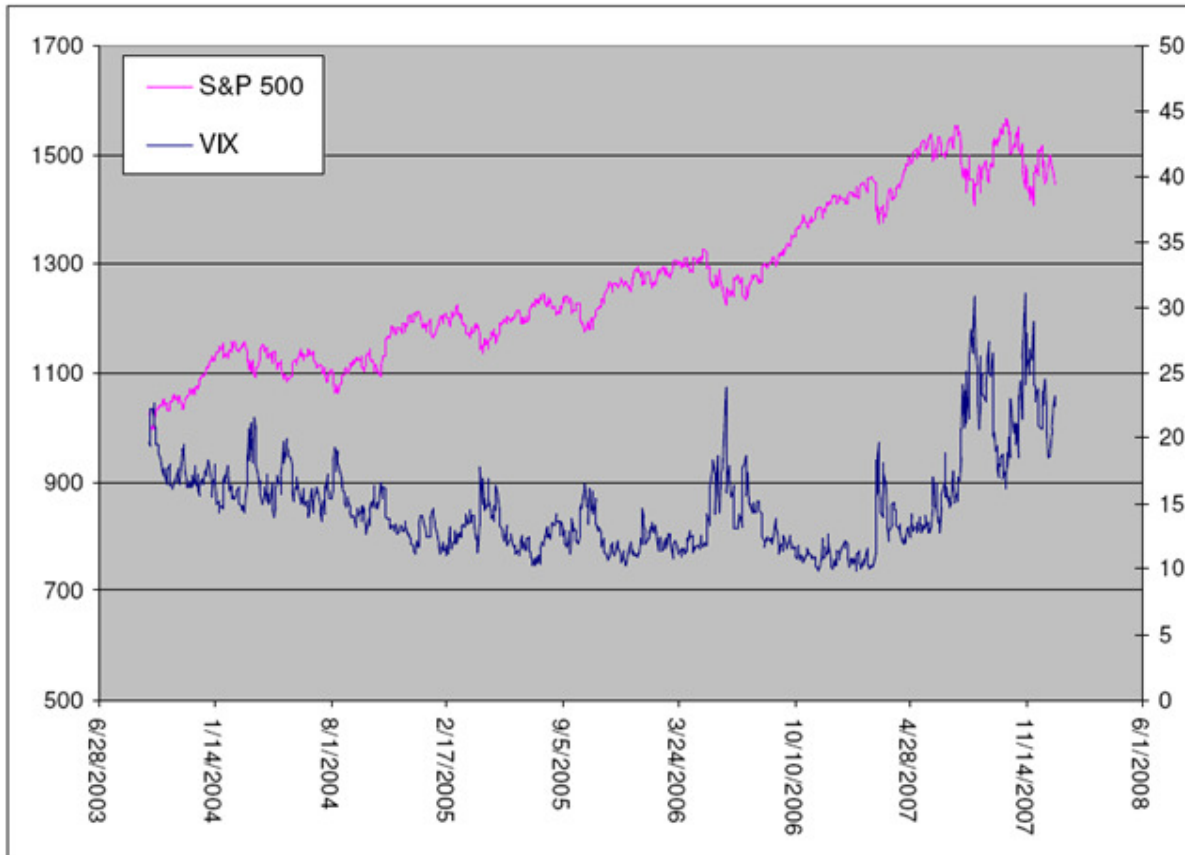
So how well has this strategy worked? Here are the results plotted together with the S&P 500:



The Arbitrage fund has beaten the S&P 500 by over 6.5% annually over the last 10 years and with less volatility. We think this fund will significantly enhance your portfolio.

Alternative Assets – The VIX Index

The VIX index or Chicago Board Options Exchange Volatility Index is a measure of the implied volatility of S&P 500 index options. It in effect measures traders' predictions of future volatility for the S&P 500. The VIX has been a useful predictor of volatility, which is typically associated with market declines. During the steep market drop in 2008, the VIX index reached extremely high levels as shown below. Until 2006 the VIX could not be purchased. Now you can buy futures contracts on the VIX.



This is of interest to us for reasons shown above. You will note that peaks in the VIX index are closely correlated with severe market drops. (You may also recall that we were monitoring the VIX in 2009 to help us decide when to begin rebalancing portfolios). In other words it appears that the VIX and their futures peak when the market drops. If we could find a way to invest in VIX futures it could provide some measure of protection in bad markets. Fortunately a new series of products are becoming available as exchange traded notes (ETN's) that actually hold VIX futures. Unfortunately since the VIX is mean reverting and provides no long term appreciation, it can create a downward drag on a portfolio when the market is rising. Thus, we believe the VIX is only useful when combined with contingent rebalancing which will "monetize" its fluctuations. We are considering using either the ETN that invests purely in the VIX futures, or another new approach in an ETN that invests in VIX futures by modeling itself after a new index called the S&P 500 Dynamic VEQTOR Index (Volatility EQUity Target Return). This index represents an investment in the broad equity market with a dynamically rebalanced volatility allocation. This ETN is becoming available in the very near future.

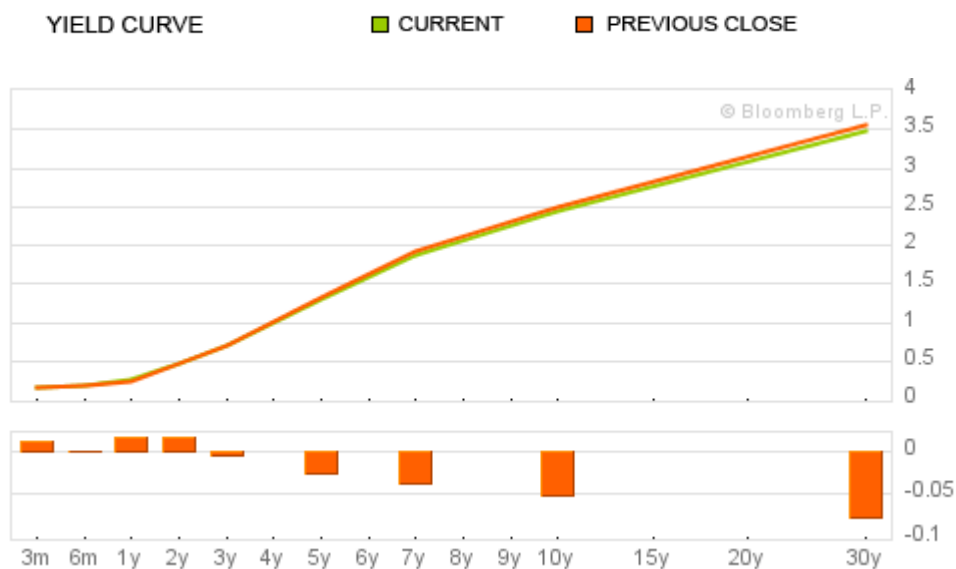
We are studying this closely and are considering using one of these ETN's as a part of the alternative asset class. The amount invested will probably be in the range of 2-4%

Fixed Income Rates and CD's

As you may have noticed, coupon rates on fixed income investment vehicles across the board have significantly decreased over the past couple of years, particularly recently. The 10-year treasury rate, which typically serves as a barometer for interest rates, recently fell below 3.00% in late June, which is quite alarming. As of August 25th, 2010, the 10 year treasury yield is currently 2.625%. See table and graph below.

U.S. Treasuries

| | COUPON | MATURITY | PRICE/YIELD | PRICE/YIELD CHANGE | TIME |
|----------|--------|------------|----------------|--------------------|-------|
| 3-Month | 0.000 | 11/26/2010 | 0.15 / .16 | 0.01 / .010 | 09:29 |
| 6-Month | 0.000 | 02/24/2011 | 0.18 / .19 | 0 / .000 | 09:07 |
| 12-Month | 0.000 | 08/25/2011 | 0.25 / .25 | 0 / .000 | 09:41 |
| 2-Year | 0.375 | 08/31/2012 | 99-25½ / .48 | 0-00+ / -.002 | 09:28 |
| 3-Year | 0.750 | 08/15/2013 | 100-05½ / .69 | 0-00+ / -.005 | 09:51 |
| 5-Year | 1.750 | 07/31/2015 | 102-06 / 1.29 | 0-04 / -.026 | 09:49 |
| 7-Year | 2.375 | 07/31/2017 | 103-07 / 1.88 | 0-08 / -.038 | 09:53 |
| 10-Year | 2.625 | 08/15/2020 | 101-21½ / 2.44 | 0-14+ / -.053 | 09:53 |
| 30-Year | 3.875 | 08/15/2040 | 107-07+ / 3.48 | 1-15½ / -.076 | 09:54 |



Inflation Indexed Treasury

| | COUPON | MATURITY | PRICE/YIELD | PRICE/YIELD CHANGE | TIME |
|---------|--------|------------|---------------|--------------------|-------|
| 5-Year | 0.500 | 04/15/2015 | 101-31 / .07 | -0-00 / .001 | 09:54 |
| 10-Year | 1.250 | 07/15/2020 | 102-25 / .95 | 0-04 / -.014 | 09:55 |
| 20-Year | 2.500 | 01/15/2029 | 116-01 / 1.50 | 0-12 / -.023 | 09:48 |
| 30-Year | 2.125 | 02/15/2040 | 111-23 / 1.62 | 0-26 / -.033 | 09:55 |

Municipal Bonds

| | CURRENT YLD | PREV YLD | CHANGE | 28% EQ YLD | 1 WK YLD | 1 MO YLD | 6 MO YLD |
|---------|------------------------|---------------------|---------------|-----------------------|---------------------|---------------------|---------------------|
| 2-Year | 0.35% | 0.36% | -0.01% | 0.49% | 0.39% | 0.42% | 0.58% |
| 5-Year | 1.20% | 1.21% | -0.01% | 1.67% | 1.28% | 1.36% | 1.55% |
| 7-Year | 1.81% | 1.82% | -0.01% | 2.51% | 1.89% | 2.03% | 2.29% |
| 10-Year | 2.55% | 2.55% | 0.00% | 3.54% | 2.60% | 2.79% | 3.11% |
| 15-Year | 3.61% | 3.61% | 0.00% | 5.01% | 3.65% | 3.77% | 3.80% |
| 20-Year | 4.02% | 4.02% | 0.00% | 5.58% | 4.03% | 4.07% | 4.10% |
| 30-Year | 4.30% | 4.31% | -0.01% | 5.97% | 4.31% | 4.37% | 4.46% |

CDs (National Average)

| | CURRENT | 1 MO PRIOR | 3 MO PRIOR | 6 MO PRIOR | 1 YR PRIOR |
|---------|----------------|-------------------|-------------------|-------------------|-------------------|
| 5-Year | 2.37 | 2.45 | 2.61 | 2.65 | 2.64 |
| 2-Year | 1.45 | 1.51 | 1.67 | 1.73 | 1.91 |
| 1-Year | 1.09 | 1.14 | 1.19 | 1.26 | 1.61 |
| 6-Month | 0.77 | 0.81 | 0.84 | 0.85 | 1.25 |
| 1-Month | 0.17 | 0.17 | 0.25 | 0.33 | 0.55 |

Recently, we have been receiving quite a few questions as to why we are using CD's rather than individual bonds for taxable and tax deferred accounts at the present time. Currently, CD rates happen to be higher at equal maturity lengths, than agencies plus they offer FDIC insurance. For clients whose tax brackets are higher, we are still continuing to use municipal bonds where it makes sense to do so for tax purposes.

Stonegate's policy is to continue to stay on the short end of the curve, using high quality fixed income in a ladder structure with maturities not exceeding 3-4 years. It is important not to lock in these low rates but instead to be prepared to reinvest pieces of the ladders at higher rates (hopefully) as they mature.

Stonegate News

1.) Stonegate Wealth Management is a participating sponsor for The New York City Magical Wedding Presented by Scotto Brothers on WPIX Morning News. It is a 21 week series that offers wedding tips and trends culminating in the selection of three finalists with the final couple winning their dream wedding.

As a sponsor, Stonegate Wealth Management will be providing a comprehensive financial plan by Cary Carbonaro, MBA, CFP® to the selected winner of the series. The final three couples hoping for their chance of winning their dream wedding will be revealed on August 18th at 8:00am on the PIX Morning News with the final couple appearing on September 8th at 8:00am. Before the final couple is announced, Cary will be appearing on WPIX NY, Channel 11 Morning

News presenting a step-by-step financial guide as well as a wedding checklist for how couples should prepare before and after their wedding.

You can watch her segment live on the air on Wednesday, September 1st, 2010, between 8:20 and 8:45am. Also, we will be posting a video clip of the presentation on our website for your viewing convenience.

Also, since it is Stonegate's view that every young bride and groom to be get their married life off on the right foot financially, we have come up with a wedding checklist which we feel is a useful tool for getting prepared financially both before and after getting married which we have entitled: "A Bride's Guide to a Successful Financial Partnership". You may view the checklist here:

<http://www.stonegatewealth.com/wedding%20checklist.pdf>

2.) Stephen Craffen has been elected to serve on NAPFA's Northeast Regional Board of Directors for 2010-2011, effective September, 2010.

3.) Steve was also recently quoted on NorthJersey.com on July 1st, 2010, entitled "Suspension of BP Dividend Hits Investors" by Rebecca Olles which weighs in on how BP cutting its dividend will affect individual investors, both locally and abroad. Steve responds with his opinion. You may view the entire article here:

http://www.stonegatewealth.com/2010_07_01_North%20Jersey.com_BP%20Div%20Suspension_Craffen.pdf

4.) Cary was recently quoted in the Orlando Sentinel's Ask an Expert column where she was asked her opinion on the safety of bonds vs stocks. You may view the entire article here:

http://www.stonegatewealth.com/2010_06_20_OSentinel_Ask%20an%20Expert_Carbonaro.pdf

5.) Stonegate is collaborating with another advisory firm to hire a consultant to write software that dramatically enhances our ability to model and analyze asset allocation strategies.

As always please call us with any questions.

Regards,

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