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The 2011 Risk List: Maximizing Investment Opportunities in an Uncertain World

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EXECUTIVE SUMMARY

There are *always* risks inherent in the financial markets. The challenge for investors is to avoid having their portfolios overexposed to the most prominent ones. In this report we analyze our Top 10 Financial Risks for 2011. More importantly, we analyze these risks with a practical, realistic lens and suggest how investors can capitalize on investment opportunities for 2011.

TOP 10 FINANCIAL RISKS FOR 2011

1. Enormous National Debt
2. Stubbornly High Unemployment
3. Limited Fed Options for Further Stimulus
4. European Debt Crisis Redux
5. Emerging Market Inflation Spillover
6. Municipal Debt Day of Reckoning
7. Emergence of China at the Expense of Developed Nations
8. Weakened U.S. Consumer Limits Economic Growth
9. Falling Real Estate Prices Impact Banks and Economy
10. Austerity Budgets Slow Global Economy

INVESTMENT IMPLICATIONS OF RISKS

We see the year-end 2010 rally more as one of “relief” rather than unbridled optimism. The rally started when Chairman Bernanke signaled QE 2 and thus placed a “put” on the market in an effort to take a double dip recession off the table. The rally accelerated as the market began to discount the results of the November election and the return of



The total U.S. Federal Debt is \$14 trillion. To place this figure in some perspective, it amounts to approximately \$47,000 per person living in America.

divided government to Washington. The rally continued at year end as it became clear that the Bush era tax cuts would be extended, albeit only for two years, thereby removing the most imminent potential drag on the economy for 2011. While investors seem largely sanguine about the stock market at the start of 2011, many risks remain.

These risks are interconnected in many respects and if one of them materializes, it could have a domino effect and trigger others. For example, excessive debt and persistent unemployment may limit spending, raise interest rates, and crimp growth. In our view, the risks will chiefly manifest themselves in volatile stock prices and rising interest rates. Our recommended strategies include:

- Exposure to the U.S. equity market, with significant downside protection and return enhancement, up to a cap, through Planned Return Strategy®.
- Obtain yield or income through investments with different return drivers.
- Exposure to emerging markets through funds with strong risk control.
- Diversification across four investment categories – Equity, Fixed Income, Hybrid, and Alternative.

INTRODUCTION TO RISK

Risk is an inextricable part of investing. Although Treasury Bills provide a seemingly riskless investment in terms of credit default, their long-term returns have been unsatisfactory, especially in a world of near zero short-term interest rates. So the challenge investors face is to have exposure to the market, but also to navigate its inherent and ever-changing risks adroitly. In this report, we discuss our view of the ten most important risks currently in the market and how we are positioning our client portfolios to maximize investment opportunities in a risky world.

RISK 1: ENORMOUS NATIONAL DEBT

The total U.S. Federal Debt is \$14 trillion. To place this figure in some perspective, it amounts to approximately \$47,000 per person living in America. The average American earns approximately \$38,000 per year and saves less than 6% of his or her income. This existing debt load is already unsustainable, yet it is still increasing each year. The trailing 12-month federal budget deficit, which is added to the total debt each year, was \$1.3 trillion. November's deficit of \$150 billion was the biggest on record and annualizes to \$1.8 trillion.



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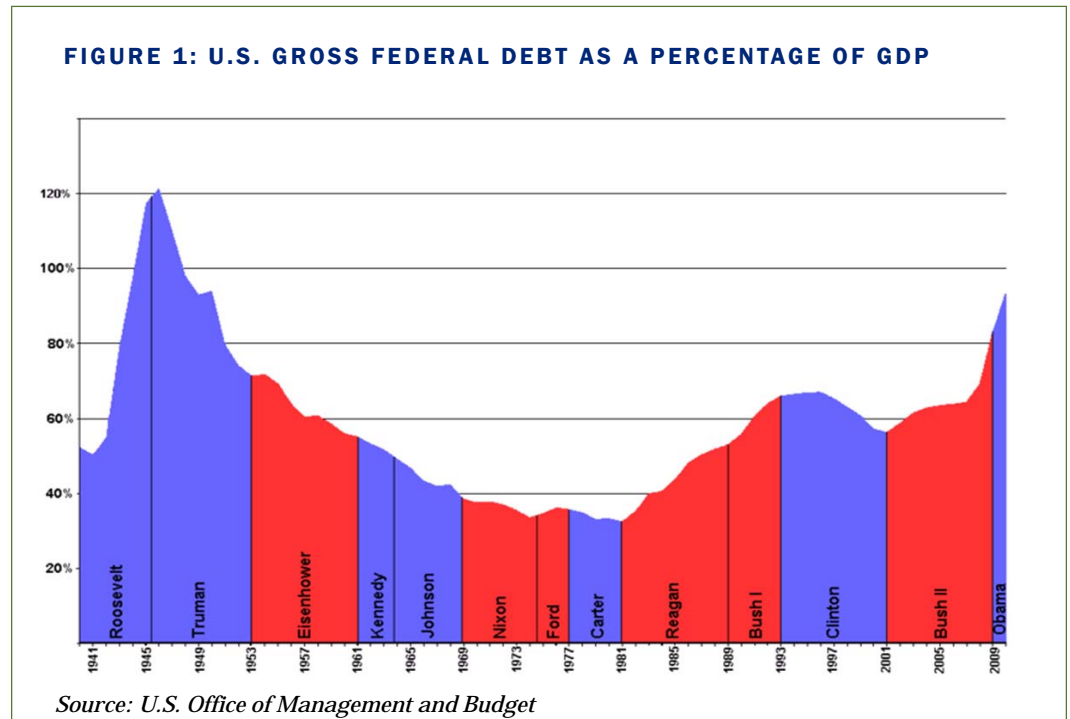


Figure 1 shows the federal debt load from a different perspective, illustrating U.S. Treasury Debt as a percentage of GDP. It is currently on its way to a level of 100%, surpassed only during the World War II era. The important difference is that after the Second World War, with most of its competitors severely damaged during the war, the U.S. was poised to experience tremendous economic growth and emerge as the world's clear superpower. Although the U.S. remains an exceptionally strong country, looking ahead, and recognizing the strong competition the U.S. faces from various corners of the world, it is difficult to see where the robust growth will come from. Therefore, we believe that the fulcrum issue for the economy is the ability to enact spending cuts while creating new pro-growth policies.

In addition to its clear economic implications, the U.S. debt has related ramifications on the foreign policy front. To the extent that China remains our largest creditor, our economic dependence on them severely constrains our negotiating position on the various foreign policy matters on which the U.S. and China have divergent interests. This weakened U.S. position further impacts negotiations on economic issues that could negatively impact our domestic economy.



The unemployment rate for December 2010 was 9.4%, down noticeably from the 9.8% figure from November 2010.

If serious debt reduction measures are not agreed upon in 2011, in our view little will get done in the 2012 election year. Kicking the debt can down the road yet again will likely make our existing problems even worse and pose an important threat to the economy and financial market performance. The two investment outcomes will likely be a higher level of interest rates and heightened market volatility.

RISK 2: STUBBORNLY HIGH UNEMPLOYMENT

The unemployment rate for December 2010 was 9.4%, down noticeably from the 9.8% figure from November 2010. However, the drop in unemployment is somewhat deceiving since it was driven, in large part, by fewer people looking for work. The economy added only 113,000 net jobs in December. Most economists view full employment in the U.S. to be in the 4% - 5% range. Economic growth is currently not strong enough to materially decrease the unemployment rate over the next year for several reasons.

First, we have new entrants to the workforce each year (e.g., college and high school graduates and dropouts) that exceed the number of people who are retiring. Therefore, the economy has to grow at roughly 2.5% - 3% annually in order to keep the unemployment rate stable. Second, unemployment relief in the form of a wave of baby boomer retirements has not played out as some analysts had projected. Many are now working longer than they expected due to the recent bear markets in stocks and real estate. Third, there are important structural changes taking place in the economy that will also keep unemployment well below its "full" rate. For example, the outsourcing of "low end" manufacturing jobs will continue. In some professions, such as nursing, there is a significant shortage, but it takes years to train someone to become a nurse (i.e., skill mismatch). Fourth, the cost of a college education has increased 100% in real terms since 1980, so it is becoming more difficult to afford a college education which may lead to a higher paying job. Lastly, corporations are hoarding cash on their balance sheets (recently a record of \$1.8 trillion) rather than hiring aggressively, due to the economic and regulatory uncertainty.

The direct investment implication of higher unemployment is reduced consumer spending, and it also acts as a damper on the real estate market. Temporary tax cuts (e.g., the new payroll tax cut) provide a short-term boost to spending. However, as with the Cash for Clunkers and the Homebuyers Tax Credit programs, economic activity will likely revert to more subdued levels once the stimulus ends. In addition, since we are



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paying for the tax cut by increasing the budget deficit, it likely raises the risk of more financial pain (i.e., higher taxes, higher interest rates, and reduced spending) down the road.

RISK 3: LIMITED FED OPTIONS FOR FURTHER STIMULUS

The Federal Reserve may have achieved the financial equivalent of painting itself in a corner. Short-term interest rates have been at or near zero for two years. The size of the Fed's Balance Sheet has gone from \$800 billion (pre- Lehman bankruptcy) to \$2.3 trillion today, and possibly as high as \$3 trillion once all rounds of quantitative easing (QE) are completed. In addition, the effectiveness of QE is hotly debated among economists.

For example, QE1 (\$2 trillion) may have helped the world avoid economic collapse, but two years after the Lehman bankruptcy, unemployment is up, and real estate prices are down. QE2 (\$600 billion) began in the second half of 2010, but its effectiveness is already questionable. The benchmark 10-Year Treasury went from 2.5% when the Fed floated the idea of QE2 in August, to approximately 3.5% today. Commodities, such as oil, copper, and sugar have also risen in price sharply. The rise in commodity prices effectively acts as a tax on the global consumer and on companies that use commodities as inputs.

One problem is that all the liquidity provided by The Fed is not effectively making its way into the economic system since banks are sitting on huge excess reserves. The banks are reluctant to lend since they still have bad loans on their books (e.g., real estate) and most credit worthy borrowers have already borrowed or refinanced. Banks have also been hit with a large dose of regulatory changes, such as the Dodd-Frank Act of 2010, which increases their costs.

The investment implication is that the Fed is increasingly impotent and is running out of tactics to effectively help the economy grow. "Bond vigilantes" have begun to push up long-term interest rates in protest of potential inflationary Fed policies. There is a material risk of interest rates continuing to go higher, despite a lack of robust economic growth. Expansion of the Fed's Balance Sheet is the equivalent of printing money. The end game will likely result in larger budget deficits, a devalued dollar, higher taxes, and less available government spending to stimulate the economy over the long-term.



A modest amount of inflation, such as 2% - 3% per year, is welcome since a rising price level helps lubricate an economy that experiences population growth and new entrants to its workforce.

RISK 4: EUROPEAN DEBT CRISIS REDUX

A crisis may have been averted in the near term with the help given to Greece and Ireland, but to what extent have the long-term fundamentals improved? Many economists have taken the U.S. to task for its (U.S. Treasury) Debt to GDP ratio of about 65%. Debt to GDP is worse in many European countries. For example, it is more than 110% in Italy and more than 70% in France, the UK, and Germany.

Compounding the over-indebtedness issue is a demographics problem. For example, the U.S. has 12.8% of its population over the age of 65, compared to 20.3% in Germany, 20.2% in Italy, 16.4% in France, and 16.2% in the UK. This means a smaller working group has to support a large elderly population, most likely through higher taxes. It is difficult to see robust growth in this kind of environment and, when combined with the mountain of debt, it would be hard to argue that the European Debt Crisis remains in the rearview mirror.

A bailout of Spain (GDP of \$1.5 trillion) or Italy (GDP of \$2.1 trillion) would likely increase the fragility of the Euro due to the larger sizes of such bailouts relative to those for countries that have already received bailout funding (e.g., Greece (GDP of \$330 billion) and Ireland (GDP of \$222 Billion)). The bailouts have the effect of a transfer of wealth from the stronger countries in the Euro (e.g., Germany and France) to the weaker ones, and there are eventual limits to their generosity. There is a precedent to currency turmoil in Europe, with the UK's exit in 1992 from the European Exchange Rate Mechanism (ERM), a precursor to the Euro.

The investment implication is that we believe there is a small, but nontrivial risk that the Euro disintegrates. If the Euro disintegrates, it could be a shock to the global financial system, analogous to the Lehman Brothers bankruptcy. To better understand the implications of the breakup of the Euro, imagine if we had to use different currencies in each of the 50 states when we travel or do business in the U.S. Contracts would have to be reworked and there would likely be many defaults as the weaker currencies were devalued.

RISK 5: EMERGING MARKET INFLATION SPILLOVER

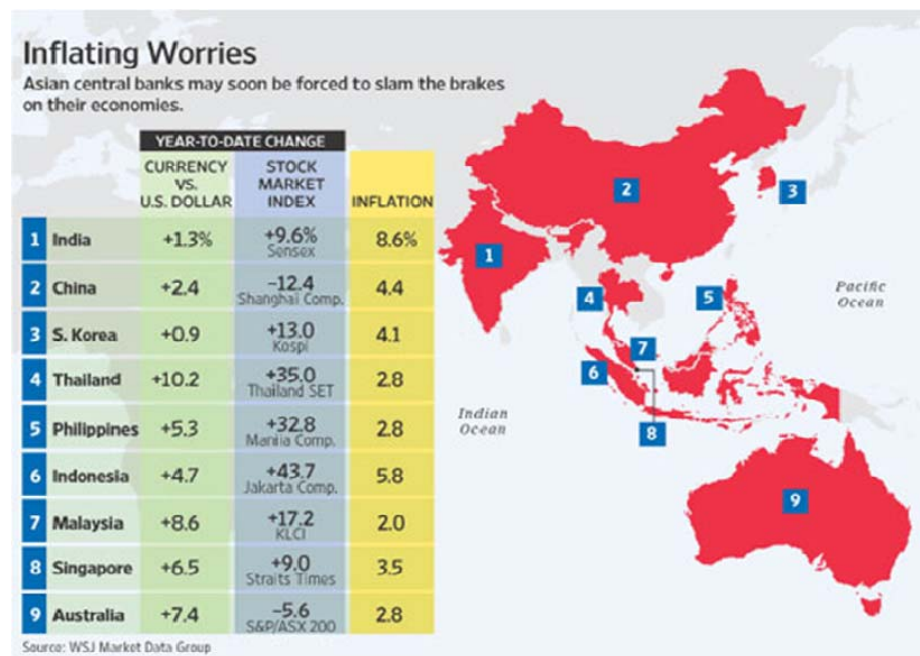
A modest amount of inflation, such as 2% - 3% per year, is welcome since a rising price level helps lubricate an economy that experiences population growth and new entrants to its workforce. However, higher levels of inflation may cause an economy to overheat and reduce the purchasing power of those living on a fixed income. Although inflation in



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the U.S. remains at a timid 1.1%, inflation rates are much higher overseas. For example, inflation is running at 8.8% per year in India and at 5.1% in China (see **Figure 2**).

FIGURE 2: INFLATION RATE FOR MANY EMERGING MARKET COUNTRIES



Higher inflation rates in the emerging markets have several implications. First, they may cause governments to take strong action to curtail these high inflationary levels, thereby causing these economies to slow. Since the emerging market economies have been major drivers of our modest worldwide recovery, to the extent these economies slow, there would likely be repercussions in the developed countries in terms of lower exports. This would have a restrictive effect on an already weak U.S. recovery. Second, emerging market inflation may eventually find its way to the developed markets, despite the latter's lack of robust growth. For example, those running factories in China or IT outsourcing companies in India may demand higher wages from their buyers. This "cost push" inflation may increase the cost of goods and services across a range of industries.

The investment implication of emerging market inflation is that the new market realities of continued volatility with slow growth and the potential for periodic crises that MDE



Unlike the federal government, municipalities cannot run the financial equivalent of the printing press to pay its bills.

portends are likely to continue. There is also a small, but nontrivial risk of outright stagflation. If emerging markets overheat and their economies pullback, it could reduce a major driver of global growth and most directly impact the multinational corporations of developed countries. From an investment perspective, we attempt to capitalize on the potential for rising rates in the emerging markets through an investment in an actively managed fund that buys short-term sovereign debt in a variety of these countries.

RISK 6: MUNICIPAL DEBT DAY OF RECKONING

Unlike the federal government, municipalities cannot run the financial equivalent of the printing press to pay its bills. Many municipalities have been hit with the “double whammy” of falling property tax receipts and lower income tax revenues due to lower employment. Moreover, much of their budget problems are driven by compensation and benefits programs for municipal workers, such as teachers, policemen, and administrators. The unions that represent these groups of workers are often much more powerful than the politicians who negotiate these contracts and are often seeking re-election.

Analysts and investors are gradually awakening to the looming credit risk problem in municipal debt. During the fourth quarter, money moved out of bond funds for the first time since November 2008. A bearish *New York Times* article on the municipal bond market was followed shortly thereafter by an even more bearish segment on the topic by *60 Minutes*. In the *60 Minutes* report, analyst Meredith Whitney predicted 50-100 defaults in American towns and cities in 2011, amounting to “hundreds of billions of dollars” of default.

Although we are concerned about the credit risk in municipals, we believe that the potential for the “muni meltdown” scenario painted by some analysts is a bit overblown. To create some perspective, there are usually less than a handful of defaults each year for the general obligation bonds of individual towns and cities, but 100 defaults per year across the entire landscape of the 26,000 municipal issuers is actually typical. The even greater number of bonds they issue encompass offerings by cities, counties, redevelopment agencies, special-purpose districts, school districts, and public utility districts and are often used to build schools, toll roads, bridges, hospitals, airports, etc.

Still, credit risk which was once an afterthought with municipal bonds due to the exceptionally low default rate of less than 0.5% per year for investment grade issues does deserve attention. There are two main investment implications for the municipal



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bond situation. First, even if there is no wholesale default among municipal bonds, state and local governments will be forced to become more fiscally responsible. This will entail cuts in services, large scale layoffs, and higher taxes. Since state and local governments are collectively the largest employer in the U.S., these layoffs will exacerbate an already tenuous unemployment situation. While all of these actions are fiscally sound, they will have constrictive effects on an already struggling economy. The second investment implication of the municipal bond situation is that credit risk analysis in selecting and monitoring issues is of prime importance. The prospect of rising long-term interest rates at the federal level also compounds the effect. Although we believe that municipal bonds still play an important role in client portfolios, we more fervently believe that investors should seek income from a number of diverse sources.

RISK 7: EMERGENCE OF CHINA AT THE EXPENSE OF DEVELOPED NATIONS

China is rapidly ascending in both economic and political power. For example, China's GDP is currently in excess of \$5 trillion, second only to the U.S.'s GDP of \$14.5 trillion, and it is growing at 8% - 10% per year. Goldman Sachs projects that China will have a GDP 2x larger than the U.S. by 2050 and greater than the U.S. plus many developed nations combined. As a further sign of its economic might, China holds \$2.65 trillion in foreign exchange reserves. Japan is next at \$1.1 trillion and the U.S. has only \$129 billion. China's huge foreign exchange reserves are due in large part to a positive trade surplus with most developed nations.

Many economists see China's persistent trade and foreign exchange surplus as a sign that its currency, the Renminbi (RMB), is artificially undervalued. China has modestly appreciated the RMB in recent years, but has persistently ignored calls to move towards a purely market based exchange rate. China has also begun to limit the supply of rare earth metals, used in the creation of many electronic items such as cell phones, computers, and televisions. China currently controls 97% of the rare earth market and has cut its export quota by 35% for the first half of 2011. Other countries do have rare earth materials, but it will take years to make mines fully operational. New reports also indicate that China has produced its first stealth fighter, perhaps a further sign of its increasing political ambitions.

The investment implication of a rising China is that the U.S. and other developed nations are increasingly not fully in control of their own economic destinies. Foreigners own 65% of U.S. Treasury debt, with the largest share (21%) owned by China. The U.S. and other countries with persistent budget deficits are reliant upon China to purchase



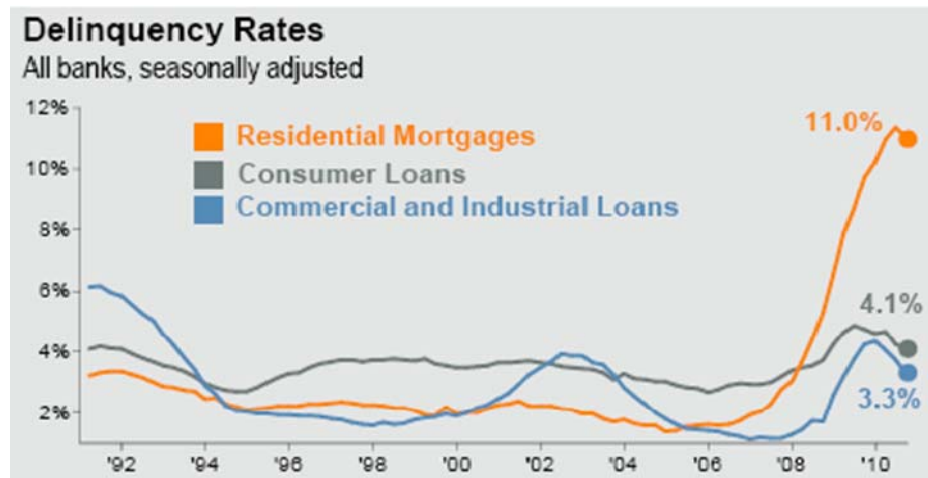
A better barometer of the retail consumer might be found in the results of Best Buy, the largest seller of electronics in the U.S. Best Buy reported a 5% drop in sales vs. the prior year.

its sovereign debt. This dependence gives the U.S. a weakened bargaining position in its effort to have China appreciate the RMB. It is almost inevitable that China will diversify its portfolio away from U.S. Treasuries, or purchase less at the margin. This would likely result in a spike in U.S. interest rates and increase the risks of higher tariffs, trade wars, and imported inflation.

RISK 8: WEAKENED U.S. CONSUMER LIMITS ECONOMIC GROWTH

Notwithstanding the rebound in the stock market over the prior two quarters, consumer spending is up only modestly. For example, “Black Friday” sales were up only 0.3% versus the prior year according to market research firm ShopperTrack. The rebound is disproportionately skewed by the affluent consumer, with firms catering to “high end” consumers, such as Tiffany, Coach, and Neiman Marcus, reporting strong results. A better barometer of the retail consumer might be found in the results of Best Buy, the largest seller of electronics in the U.S. Best Buy reported a 5% drop in sales vs. the prior year. Consumer spending may have received an artificial boost from a new dynamic dubbed by the media as “frugal fatigue.” That is, some consumers are tired of being frugal and have resumed spending even though they likely cannot afford it.

FIGURE 3



Source J.P. Morgan

Figure 3 above shows that consumer delinquency rates are still at elevated levels, although down somewhat from the depths of the financial crisis. The high levels of delinquencies also increase the risk of banks. For example, banks are often saddled with



Zillow.com, a leading real estate firm, estimates home prices will fall 10% in 2011. If such a drop occurs it may further damage a fragile housing sector.

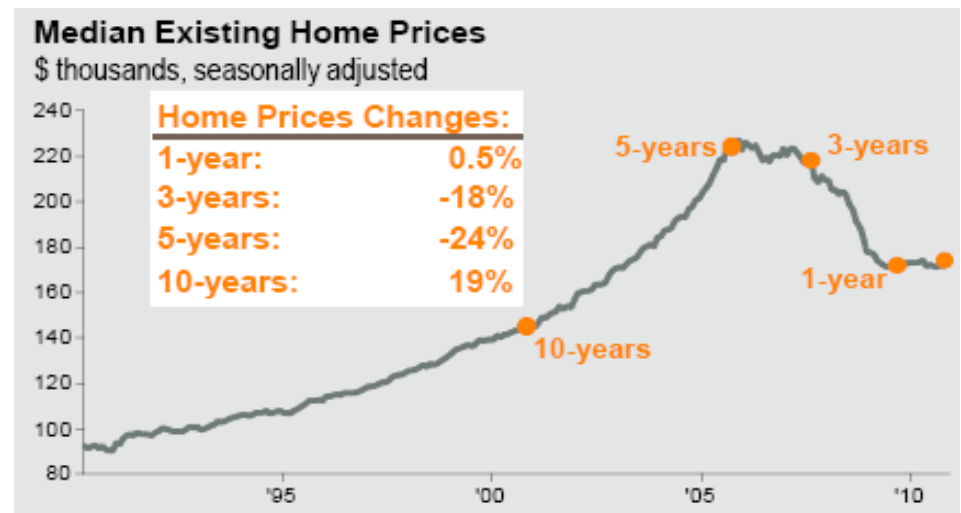
bad real estate, as many U.S. consumers leave homes that are financially “underwater.” Additionally, the declaration of bankruptcy by consumers often absolves them of much of their bank credit card debt. Banks have been slow to “mark to market” their loan portfolios and may be in poorer financial health than generally understood by the market. In our view, this may explain why they have been reluctant to increase lending materially, while continuing to increase their reserves.

Since consumer spending accounts for roughly two-thirds of the U.S. GDP, it is difficult to envision a robust economy until the financial health of consumers noticeably improves. The most important element that drives consumer spending is employment, which we discussed in **Risk 2** (page 4) as being at historically low levels. The main investment implication is that a weakened U.S. consumer likely ensures that the new market realities of continued volatility with slow growth and the potential for periodic crises will be with us for the foreseeable future.

RISK 9: FALLING REAL ESTATE PRICES IMPACT BANKS AND ECONOMY

Real estate prices have fallen approximately 25% from their peak in 2006, as shown in **Figure 4**. Prices have stabilized somewhat recently due to near record low interest rates, a moratorium on foreclosures, a wave of refinancing, and government tax credits. Many of these temporary programs have ended or are coming to an end. Housing

FIGURE 4



Source J.P. Morgan



Slowly, across the American landscape there appears to be a growing realization that excessive debt must be confronted with a combination of changes in spending and policies that encourage growth.

inventory continues to rise due to an influx of consumers walking away from their homes, which are financially underwater.

Zillow.com, a leading real estate firm, estimates home prices will fall 10% in 2011. If such a drop occurs it may further damage a fragile housing sector. The fate of home prices has wide ranging implications for the economy and financial markets. Homes are still the largest portion of net worth for the majority of Americans. Material drops in home prices are, in some respects, a direct assault on the American dream. If consumers lose confidence, as well as wealth, they are likely to spend less, directly impacting the biggest portion of GDP. Banks are holding the bulk of mortgages.

Further write-downs of a substantial nature are likely to impact their lending activities. Indeed, due to the high leverage employment by many banks, a sharp drop in real estate prices may threaten the very existence of the weaker ones. Additional bank bailouts are unlikely to be tolerated by a still resentful populace. The risk of another banking emergency, albeit not as severe as the last one, remains — especially in the event of plunging real estate prices.

RISK 10: AUSTERITY BUDGETS SLOW GLOBAL ECONOMY

Austerity budgets are increasingly becoming a way of life in Europe, although not without strong protest. Generous pension, vacation, and health benefits are being slashed, as a condition for accepting bailout funds for countries, such as Greece and Ireland. Portugal, Spain, and Italy also have serious fiscal problems that may require a bailout from the stronger European countries (e.g., Germany, France) and possibly the International Monetary Fund (IMF).

Slowly, across the American landscape there appears to be a growing realization that excessive debt must be confronted with a combination of changes in spending and policies that encourage growth. President Obama announced a small step with his proposal to freeze salaries of all federal workers for the next two years. Governor Christie of New Jersey has been tapped by some political analysts as a potential Republican Presidential candidate for 2012 due to the large spending cuts he enacted in an effort to get his state's budget on more sustainable footing.

Although austerity budgets, or keeping spending in line with revenues, are a wise decision over the long-term, it may result in global turmoil in the short to intermediate term. Economists have termed this problem the “paradox of thrift.” At the extreme, if everyone is saving, no one is buying. As sales are reduced, unemployment increases



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further, resulting in a vicious cycle of even fewer sales and higher unemployment. The investment outcome of a global austerity program will likely be slower growth and heightened market volatility. While seemingly unthinkable in the U.S., draconian austerity budgets could even lead to social unrest similar to that seen in Europe.

FINDING INVESTMENT OPPORTUNITIES AMID THE RISKS

There are *always* risks inherent in the financial markets. The challenge for investors is to avoid having their portfolios overexposed to the most prominent ones. Given the **Top 10 Financial Risks for 2011** discussed in this report, MDE has crafted an investment strategy that best enables our clients to capitalize on the opportunities that remain. We have reached four primary investment conclusions:

1. Exposure to the U.S. equity market, with significant downside protection and return enhancement, up to a cap, through MDE's Planned Return Strategy®.
2. Obtain yield or income through investments with different return drivers.
3. Exposure to emerging markets through funds with strong risk control.
4. Diversification across four investment categories – Equity, Fixed Income, Hybrid, and Alternative.

To further make this advice actionable, MDE has created **Guide Portfolios** that consist of specific investments for our clients. These portfolios are a starting point for discussion and ultimately tailored to each client's unique goals and objectives. **Table 1** on the following page, lists the Q1 2011 Guide Portfolio for an investor of "moderate" risk tolerance. Separately managed account (SMA) investments require larger minimum investments relative to mutual funds (MF), so we break out these two portfolios separately. The net effect of these investment strategies is to be in the market, but diversify as much as possible across the risk exposures investors face. By giving careful consideration to the risks in our Risk List, investors can build portfolios better positioned for success in the year ahead.



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Table 1: Risk 3.0™ Guide Portfolios

MANAGER BY ASSET CLASS	SMA MODERATE	MF MODERATE
Equity	44.00%	30.00%
Planned Return Strategy® 2x SPY w/ 12% Buffer	30.00%	
Third Rail™ 1X SPY w/ -15% to -40% Third Rail Buffer		
Schafer Cullen High Dividend	5.00%	5.00%
Harding Loevner Global Equity	5.00%	5.00%
Kinetics Paradigm		5.00%
Marsico Focus		5.00%
Manning & Napier Pro-Blend Max Term		5.00%
Emerging Markets Equity	4.00%	5.00%
Hybrid	25.00%	34.00%
Steelpath MLP Alpha	4.00%	6.00%
Lazard Emerging Income	4.00%	
Nuveen High Yield Muni	4.00%	6.00%
Loomis Bond Fund	4.00%	6.00%
FPA Crescent	5.00%	8.00%
Permanent Portfolio	4.00%	8.00%
Alternative	20.00%	20.00%
TAF	5.00%	
Titan	5.00%	
AQR Diversified Arbitrage	4.00%	5.00%
Highbridge Statistical Market Neutral		5.00%
JPM Strategic Income Opportunities	3.00%	5.00%
TFS Market Neutral	3.00%	5.00%
Fixed Income	10.00%	14.00%
Breckinridge	5.00%	7.00%
Pimco Total Return	5.00%	7.00%
Cash	1.00%	2.00%
Money Market Fund	1.00%	2.00%
Total	100.00%	100.00%



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