INVESTMENT MANAGEMENT & CONSULTING GROUP

VIEWPOINTS

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MARKET COMMENTARY FREDRIC W. WILLIAMS

Sublime Sub-prime…

With all deference to the sensitive psyches of the Neanderthals in Geico's commercials, you would have had to inhabit a cave over the last several months to not have heard about "sub-prime" mortgages and their potential impact on the housing market and the economy at large. The media banter has focused on both the lending practices that have brought this problem on, as well as the potential spillover effect that foreclosures may have on housing prices and consumer spending.

> *"With subprime mortgage lenders pulling back, some working-class Americans are already finding it harder to buy a new home or refinance the one they already own. The big question now for the nation's economy: Will it also get harder for these consumers to buy cars, shop at the mall and dine out?"*
>
> *"Like many American families, subprime borrowers -- consumers with poor or sketchy credit histories -- have been able to use the combination of rising home prices and easy credit to live beyond their means in recent years as wages have stagnated. That spending has helped to fuel the U.S. economy's growth."*
>
> *"Today, with the housing market in a slump and defaults mounting in the market for subprime home loans, some economists believe more lenders will tighten credit standards in the months ahead as concerns grow about Americans' heavy debt load and their ability to manage it."*
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> *"Such a spillover might force consumers to rein in spending, particularly lower-income Americans, who have piled up debt at a faster clip than their wealthier counterparts in the past decade. That could be a headache for the retailers, restaurateurs and others who depend on their business."* *WSJ 4/2/07*

In addition to the resulting refinancing and spending difficulties in this end of the credit spectrum, we see a number of other impacts from the unwinding of this housing related asset bubble. We're already seeing glimpses of bankruptcies in the lender area (New Century filed for Chapter 11 protection on 4/2), which will impact shareholders, regardless as to their credit score. There will be collateral damage in the bond market as these lenders repackaged their sub prime loans in RMBAs (Residential Mortgage Backed Asset) or CDO (Collateralized Debt Obligation) which will marketed by the financial services industry as investment grade paper – which they obviously are not. The fund and investor losses may not

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be huge, but will reverberate through the fixed income markets for a while as the losses, and blame, are tabulated. Many of these loans, now we're finding out, were no-doc loans where no financial information was provided in the income or financial sections of the 1003, and no effort was made by the lender to ascertain said data. It would appear that the litigators, and regulators, are going to have a field day with the mortgage brokers who pushed these under-capitalized borrowers through the system, or set them up with teaser-rate loans that were destined to blow up once the interest rate was market adjusted.

Between tighter lending standards and potentially increasing foreclosures, it would appear that the number of qualified buyers will be decreasing right at the time that the housing supply is increasing. Economics 101 would indicate that the cost of supply will have to decline until it meets a price that is supported by demand…a level which would appear to be somewhat lower than what we see today.

Some thoughts on how some of these variables might play out over the next 6 to 18 months:

> *"…estimate of the impact on the housing markets of the increased standards, coupled with the demise of interest-only and teaser-rate loans. It is highly likely that the buyers of 10% of the homes that were sold in the last two years would not have qualified to buy those houses, and it is possible it could be 15% or more. That would have probably taken a lot of the irrational exuberance from the housing market, and avoided the bubble and the aftermath."*
>
> *"If you take 10-15% of the potential buyers from the market going forward, that is a serious problem, especially as you are adding homes to the market from foreclosures. The notion that we saw a bottoming of the housing market in January is ludicrous. Housing bottoms take years to accomplish, not a few quarters."*
>
> *"The top of home prices was in October of 2005. Borrowers who are trying to refinance their mortgages are going to come under increased pressure in many markets, as home values slide below their loan values. They may be stuck with their high adjustable-rate mortgages or lose their homes."*
>
> *John Mauldin Frontline Thoughts 3/2/2007*

> *"Subprime mortgages were about 20% of the market in 2005-6. Already almost 12% of those mortgages are in some part of the foreclosure process, with anecdotal evidence that the number is going to increase. The prediction late last year by the Center for Responsible Lending that as many as 20% of the subprime loans made in the last two years would end in foreclosure does not look as Cassandra-like when it first was made. The CLR study suggests that as many as 2.2 million people will lose their homes."*
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> *"If you put just 4% (and it could be more!) of the homes sold in the last two years back on the market within the next six months, it is going to have a serious effect on housing valuations. While anecdotal evidence suggests home prices in many areas are starting to fall, lenders have not yet capitulated."*
>
> *John Mauldin Frontline Thoughts 3/17/07*

Our concern is that the housing market was such a big part of the post-9/11 economic expansion on the upside that we struggle to see why it couldn't have a similar effect on the downside:

> *"If risky borrowing helped propel the housing market during the boom times, lenders cutting back on the number of risky loans they make could cause some of the demand for housing to evaporate, and home prices could get pushed lower. That, in turn, would put more homeowners underwater on their mortgages -- which is a big part of how the subprime fiasco got started in the first place."* *WSJ 4/2/07*

The "perfect storm" in the deflating housing bubble could potentially arise from this increasing supply of unsold homes producing lower housing prices and a reverse wealth effect with consumers, causing them to curtail their spending as house values (and their home equity lines) shrink, thereby by exacerbating an already slowing economy.

As we've discussed in the past, these dynamics continue to support our cautious view of the future - we'll continue to adhere to our moderate expectations that emphasize global diversification along with cash flow oriented asset allocations – our goal still being to, over time, generate real rates of return and mitigate volatility.

EQUITY MARKET OVERVIEW — INVESTMENT POLICY COMMITTEE

Shanghai-ed…

The initial two thirds of the first quarter of 2007 seemed to be a continuation of the last portion of 2006, with the domestic equity markets continuing to hit new highs, closing at 12,786.62 for the first time in mid February. Then a funny thing happened on the way to the ATM – the People's Bank of China, for the fifth time in eight months on February 27th, increased the required cash reserves that lenders must park with the nation's central bank. Intended to drain liquidity from the banking system and slow down the torrid growth in lending, which grew 16% last year, the collateral result was a more than 9% decline in Shanghai's share prices. Combined with former Fed Chairman Greenspan's comments about the possibility for a U.S. recession later in the year, this caused a near-global retracing in equity markets, with the DJIA eventually touching a relative low of 12,050.41 approximately 2 weeks later.

Although almost half of this decline had been reversed by the end of the quarter, it marked the re-emergence of a market emotion (fear) that had been absent since last spring's correction. Riding on the coat tails of the private equity funds and their apparent unending appetite for buy out deals, the market drop (along with declining home prices and rising energy costs) reintroduced risk to the investor mindset and landscape. This has been manifest in an increase in the CBOE Volatility Index (VIX), as well as a widening of credit spreads in the fixed income arena, resulting in muted total returns and a trading range mentality for the last third of the quarter.

The complacency of the new year, as well as the rebound from the lows, was held in check at quarter end by the Iranian trifecta: ongoing concern about their nuclear program and its intentions, the recently detained British hostages, and the impact that both could have on the oil market, which had climbed 7.9% in the first quarter alone.

With regard to the domestic equity markets, the Dow Jones Industrial Average ended the quarter down 0.9%, at 12354.35, including the 416.02 point plunge on February 27th. The DJIA has rebounded 2.5% since hitting a closing low March 5 (12,050.41), but remains 2.2% below its level before the one-day sell off. An uncertain economy left the broad S&P 500-stock index little changed for the quarter, up 0.2% to 1420.86, while the tech-stock-focused Nasdaq Composite Index ended the quarter up 0.3% at 2421.64 and the small-stock Russell 2000 index gained 1.7% to end at 800.71.

The quarter's volatility, and relatively benign outcome, has the professional prognosticators juggling a variety of potential outcomes to the current list of economic and geo-political challenges:

> *"Though they could be wrong again, expectations for the next few months are modest at best, with little hope for a significant rally as investors battle fears about the impact of mortgage defaults and the housing downturn on the economy. Other looming hazards include slowing corporate earnings growth, energy prices that have crept higher lately and lingering uncertainty about the Fed's next move." WSJ 4/2/07*

Once again, overseas markets provided relative out-performance, keeping the 4 year rally intact, but not without a hint of drama as events in China, along with developments in the U.S. economy, began to play out in a variety of "what if" scenarios.

> *"The pullback began the last week of February amid signs that loans to the least creditworthy U.S. borrowers, known as sub-prime loans, were deteriorating. Investors worried that delinquencies in this corner of the property market could spread to the broader housing sector, damping U.S. consumer appetites for foreign goods and commodities. Global markets suffered their biggest one-day sell off Feb. 27, with blue-chip indexes falling between 3% and 7%, after a nearly 9% drop in Shanghai's main stock index further unsettled nerves." WSJ 4/2/07*

Despite these worries, European bourses, buoyed by the regions steady economic expansion, ended the first quarter in the black, with London's FTSE-100 up 1.4% the Paris CAC-40 1.7% higher and Frankfurt's DAX ahead by 4.9%. The Nikkei 225 had a rougher go of it, dropping 9% the last week of February in sympathy with their Chinese neighbors, and was only able to manage a 0.4% gain for the quarter. Additionally, fissures appeared in the emerging markets as their overall performance was merely breakeven, unlike previous quarters where they greatly outpaced the developed world.

Although continually evaluating opportunities domestically, we still see the balance of 2007 as another year to maintain, and develop, our exposure overseas, primarily in the developed world. We can find more reasonable valuations there as well as the opportunity to benefit from a weaker dollar.

Encore Une Fois…

Once again this quarter, all eyes were on the F.O.M.C., and the commentary released after its two quarterly meetings, in an attempt to read the tea leaves of future interest rate direction. Much like every meeting since the last increase in June 2006, the Fed opted to stand pat (both in January and March), leaving federal fund rates at 5.25%. The only slight change in the March release was absence of a specific reference to "any additional firming", which resulted in the 100 point-plus pop in the Dow immediately after the announcement.

The 10-year yield opened the year at 4.708%, traded as high as approximately 4.9% and as low as 4.5%, before closing the quarter at 4.65%, and restoring a positive yield curve between 2 and 10 years. Interestingly enough, and despite any significant down draft in rates, the domestic bond market outperformed their equity brethren, with the intermediate maturities almost doubling the total return of the long end of the market.

The Fed is beginning to find itself between a rock and a hard place as continued weakness in housing is slowing the economy, and potentially calling for rate cuts. The weakness in the dollar could be exacerbated by lower rates and cause issues with our trading partners, notably China. This could result in a demand for *higher* rates to offset the currency decline. Rising rates, however, would adversely impact the government's current account deficit financing, and exacerbat the woes in the already reeling sub-prime mortgage market. The rub would be if continued dollar weakness causes the Chinese central bank to sell, or simply stop buying, U.S. assets – primarily government bonds – which could lead to a spike in interest rates and further weaken a slowing domestic economy.

Above and beyond the aforementioned issues in the domestic housing market, the economy has been sending mixed messages for a while. Wage and employment data have remained relatively strong, yet we have record levels of credit and secured debt. Consumer spending, at least to this point in time, continues to grow, but at a level that exceeds GDP and is not sustainable over the longer term. Additionally, the annual rate of inflation has stayed stubbornly above the levels generally believed to be in the comfort zone for the Fed to consider cutting rates, making that hard place even harder.

Concerns focus on the impact that a slowing economy (and housing market) could have on the consumer's inclination to spend, either from cash flow on an increase in debt. As previously mentioned consumer activity represents nearly 2/3 of the GDP and could have a considerable impact on economic growth if the wallet gets closed or the credit cards stop getting used.

A recent slowdown in productivity may become an issue for Chairman Bernanke going forward. Unlike the late 1990's, when an acceleration in productivity allowed for faster growth and lower unemployment, while providing cover for lower inflation and lower interest rates, current slower productivity growth is a risk to living standards, retirement benefits and inflationary pressures.

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The 2.6% average rate between 1995 and 2000 grew to 4% by 2004, but has steadily declined since then, falling to just 1.4% in the 4th quarter of last year.

> *"Lower productivity growth means an increase in wages is more likely to translate into narrower profit margins or higher prices, which could prompt the Fed to tighten monetary policy. Because higher interest rates curb demand by making borrowing more costly, they also make it harder for firms to raise prices and wages."*
> *WSJ 3/31/07*

As stated in the recent past, given the headwinds from continued weakness in the housing market and the resulting potential for a slowing economy, as well as the impact that a weaker dollar may have on the inflation front, we will continue to be at the short to intermediate end of the yield curve where we have the most flexibility in adapting to which ever set of circumstances prevails going forward.

WEALTH MANAGEMENT UPDATE — TRACY W. ROGERS

Long Term Care – Risk Management Strategies & Analysis…

This is a subject that strikes fear in many of our hearts, but we wanted to take some time to review a few statistics, as well as outline our wealth management perspective on these asset preservation strategies. As you know, we are not insurance salespeople, nor are we trying to push LTC insurance, but we would be remiss if we did not discuss the risks and potential solutions with our clients. Many of whom have watched family members or friends erode their asset base paying for care, and have a concern about their future financial security given the ever increasing cost of health care. Our position is that there are three elements to planning for the long-term care needs of family members or ourselves: emotionally planning for it; physically providing it; and lastly, financially paying for it. Everyone's situation is different, as are their needs and goals for if or when this happens. Financially, you can bear the risk yourself (self- insure) or transfer to an insurance company by purchasing a policy. None of us think twice about paying for auto or home insurance while hoping we never use it. We have yet to meet anyone that 'wants' to use LTC insurance either.

WHAT IS LONG-TERM CARE?

Long-term care is the help needed to cope with and sometimes survive a chronic disability such as arthritis, heart disease, stroke or memory loss which impairs your capacity to perform the basic activities of everyday living. Today, it includes a broad range of supportive medical, personal and social services which can be provided in a nursing home, your own home, an adult-day care facility, or an assisted living facility. There are three levels of care: skilled (or acute) care; intermediate care; and custodial (or personal) care. Custodial is by far the most common.

WHAT ARE THE ODDS YOU OR YOUR SPOUSE WILL NEED LONG-TERM CARE?

According to the Health Insurance Association of America, your risk of needing long-term care at age 50 is one in five. At age 65, it's four in 10. and at age 75, it's seven in 10. That's significant. The average stay is two and one-half years. About 10% stay five years or longer.

Nursing Home Costs

Most seniors will spend less than three years in a nursing home facility, at an average cost of approximately $66,000 annually. Accordingly, while 84 percent of seniors will incur long-term care expenses of less than $100,000, 11 percent will incur costs between $100,000 and $250,000, and an additional 5 percent will get hit with expenses over $250,000. As a result, some could see their life savings wiped out by nursing home costs.

The Medicaid Option

Medicaid is a joint federal and state program that covers medical bills for the needy. If you qualify, it will pay for your long-term care costs. Unfortunately, Medicaid is welfare. In order to qualify, you'll have to spend down your assets. State law determines the allowable income and resource limits. If you have even one dollar of income or assets in excess of these limits, you will not be eligible for Medicaid. To receive Medicaid assistance, you'll have to transfer your assets to meet those limits. This can be tricky, however, because there are tough laws designed to discourage asset transfers for purposes of qualifying for Medicaid.

Rate Creep

Another alarming fact is the rising cost of the long-term care policies themselves. Many times we have clients ask if they should buy the policy now or wait until they are older. This is not an easy answer. In the past 10 years there has been considerable consolidation in the long term care insurance industry. Because the policies are relatively new, many of the projections about care rates, renewals costs and claims were underestimated, resulting in what used to be 100 companies offering policies having now shrunk dramatically. Roughly every two years insurance companies come out with new policies and although these policies contain many new benefits and features, they also are more expensive for new people signing up than the previous policy. Estimates are, because of this rate creep, new applicants for long-term care insurance are paying about 5% more each year than applicants at the same age would be paying with older policies. At this rate of increase, ten years from now, a policy for a 50 year old would cost 50% more than an equivalent policy for a 50-year old would cost today.

In closing, we want to make sure we discuss long-term care planning with clients that it applies to, whether it is preserving your assets for spouse or children, maintaining dignity, or deflecting a perceived burden to children, spouse or siblings. All of these are relevant and should be discussed. There are new products that have been introduced, as well as new strategies from the legal perspective, and we can facilitate meetings with outside professionals to discuss which combination of strategies will best serve your goals and objectives.

Inside The Markets — Francis J. Davies III

Retirement Plan Costs Draw Scrutiny…

Our approach at IMCG emphasizes transparency – the right of the client to know how their assets are being managed and what they are paying for that management, regardless as to whether it is in our clients directly managed portfolios, or within their 401(k)/403(b) retirement plans. Full disclosure is integral part of our responsibilities as a fiduciary. We also believe that approach is essential in our role as your plan consultant.

A failure to clearly disclose costs has the Congress examining pension plans. While this issue has not received much publicity in the general press, it concerns all of us with pension plan holdings. The Labor Department wants to level the field so plan participants know what they are paying.

We would never suggest that the benefits of fully contributing to your pension are outweighed by inflated plan costs. It is just an instance of large financial firms overcharging the public and burying the costs in a blizzard of legalese found in footnotes of footnotes, in the back of an obscure document. As proponents of honesty in the financial field, we find this troubling.

The problem lies in the bundling or "wrapping" of different fees into one charge. This is a common problem in retail oriented financial products. But it is no easy to argue against an industry with an unlimited budget for slick and deceptive advertising.

The sponsor of a 401(k) or 403(b) plan (normally the employer) usually hires a mutual-fund company or an insurance firm to run the plan. That company charges the sponsor for investing the funds and administering the plan. The problem is that different costs are not broken out so that comparison shopping is difficult.

On March 6, the House Education and Labor Committee held the first of what may be several hearings on the costs associated with 401(k) plans. Like all investigations into broadly marketed financial products, the news is bound to be ugly. As your financial advisors, IMCG recommends that you pay attention to developments of this story. Take the opportunity to ask questions about your plan fees and make sure that they are reasonable.

IMCG NEWS

IBBOTSON ASSET ALLOCATION CONFERENCE: This annual meeting, the first since Morningstar acquired Ibbotson Associates, was attended by Fred this year during early March. The 2 day symposium focused on macro market themes, along with longer term economic forecasts, and featured a variety of speakers including Roger Ibbotson and Don Phillips, President of Morningstar.

14TH ANNUAL DREAM FACTORY "*Child's Play*" GOLF BENEFIT: IMCG is pleased to once again this year be a co-sponsor of this event. It will be Friday afternoon June 1st at Sable Oaks Golf Club and will be followed by a lobster bake and awards ceremony. In addition this year, later that evening at the adjacent Marriott Hotel, local performers Motor Booty Affair will be holding a benefit dance party for golfers and non-golfers alike.

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