INVESTMENT MANAGEMENT & CONSULTING GROUP

VIEWPOINTS

2ND QUARTER 2007 — *ADVISORY NEWSLETTER*

MARKET COMMENTARY — FREDRIC W. WILLIAMS

Redux Review…

Having hit the mid year mark, we thought it appropriate to revisit a couple of the macro themes we're focusing on as we steer a course through the capital markets and the vagaries that influence their movements and trends. Since the markets, by definition, are based on future perceptions of value, gaining an understanding of what can impact those views can aide in the asset allocation process over the longer term.

Since revenues (business activity) drive profits and then relative valuations, we see GDP trends as an important canary in the mine influencing future market direction. With approximately two thirds of GDP being a function of consumer activity, we consider anything that would impact their behavior to be significant. We can hearken back to the late '90's when investors were blissfully riding the "new paradigm" wave, ignoring the rules of diversification and reasonable price/earnings multiples, and found themselves overly concentrated in the tech bubble. That wave dashed them on the rocks and the negative wealth effect caused by their greatly diminished portfolios and 401(k) plans was a contributing factor in the resulting recession.

Seven years later we fear another bubble, this time in residential real estate, is beginning to have some of its air released. Like any other commodity to be priced in a free market economy, housing is priced as a result of sellers and buyers (supply and demand) determining what current "value" is represented by. Much like the NASDAQ-centric investor's whine in early 2001, there is no credence to what something *was* valued at in the past – the harsh reality then is the same dynamic now: it *is* what it *is*.

On the supply side we continue to see signs of overbuilding leading to a glut of unsold homes – to say nothing of the homes for sale that are not currently finding buyers. According to ZipRealty Inc., a national real estate brokerage based in Emeryville, CA, the number of homes on the market in the 18 major metropolitan areas was up 2.5% from May. Additionally, for the 15 cities for which year earlier comparisons were available, the inventory increase was 23%. The S&P/Case-Shiller index (10 major metropolitan areas dating back to 1987) dropped 2.7% (year over year) in April, the fastest decline in 16 years. The more comprehensive 20 city index (dating back to 2001) dropped a record 2.1% year over year. Economics 101 would teach us that when supply exceeds demand, prices need to be further reduced to a level that will attract the necessary buyers…a bitter pill for both developers and home owners to swallow.

The demand side of the housing equation has a variety of issues, the simplest being that rates are higher now than they were 2-3 years ago…higher rates mean bigger mortgage payments, which in turn means reduced relative demand for the inventory that currently exists.

An even more significant impact on demand (and perhaps supply) will be the resets to adjustable rate mortgages (ARMs) that were sold with low teaser rates and are now going to be marked to market. Many of the ARM-buyers qualified at the 1% rate (barely) and will face a significant increase in their monthly payments as these get "adjusted" to current market rates in the 6-7% area:

> *"Those that point to a crisis averted and a return to normalcy are really looking for contagion in all the wrong places. Because the problem lies not in a Bear Stearns hedge fund that can be papered over with 100 cents on the dollar marks. The flaw resides in the Summerlin suburbs of Las Vegas, Nevada, in the extended city limits of Chicago headed west towards Rockford, and yes, the naked (and empty) rows of multistoried condos in Miami, Florida. The flaw, dear readers, lies in the homes that were financed with cheap and in some cases gratuitous money in 2004, 2005, and 2006. Because while the Bear hedge funds are now primarily history, those millions and millions of homes are not. They're not going anywhere…except for their mortgages that is. Mortgage payments are going up, up, and up…and so are delinquencies and defaults. A recent research piece by Bank of America estimates that approximately $500 billion of adjustable rate mortgages are scheduled to reset skyward in 2007 by an average of over 200 basis points. 2008 holds even more surprises with nearly $700 billion ARMS subject to reset, nearly ¾ of which are subprimes."* *Bill Gross; PIMCO, July 2007*

[See ***Taking the Mystery out of Hedge Funds*** on page 8 for more on Bear Stearns and the collapse of the sub prime market.]

So the double edged sword here is that market rates will be less affordable to more buyers (thereby curtailing demand) and the resulting foreclosures will add more homes to the already bloated inventories and increasing supply and the resulting downward pressure on prices/values.

> *"The Center for Responsible Lending estimates that 2.2 million borrowers who got subprime loans since 1998 either have lost or will lose their homes through foreclosure over the next few years. This includes one of every five borrowers who got subprime loans in 2005-06, a default rate unmatched in the history of the modern mortgage market."* *John Mauldin; June 30, 2007*

As we said last quarter:

> *"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."

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

Private Equity Fireworks…

After posting a slight decline in the first quarter of the year, the domestic markets opened the current quarter with a string of eight straight advances, the longest run in four years. Driving these gains was optimism on the corporate profits front, as well as the ongoing merger and acquisition drum beat coming from the private equity funds as they attempted to allocate the massive amounts of liquidity that had been directed into their coffers. Although new highs were hit in the major indices, the heavy lifting was done during deal crazed April and May – June was actually a down month for the domestic equity markets.

Mergers and acquisitions were the driving force behind the markets' advances during the first two months of the quarter, and have left an indelible "deal premium" in equity prices as traders await the next buy out announcement:

"Companies around the world struck $1.65 trillion of merger deals in the second quarter, eclipsing the first quarter of 2000 as the biggest three-month total, according to data tracker Thomson Financial…That is a 90% increase from the same period in 2006, which racked up a full-year deal-making total of $3.6 trillion, the best on record. With deal volume in the first quarter of this year rising 28% to just under $1 trillion, that 2006 record would be easily shattered if the pace of the first half of 2007 is sustained.

"The second quarter could end up being a high-water mark, as the flood of cheap credit that has lubricated the buyout boom shows signs of ebbing. Bond and loan investors in recent days have forced a raft of companies that are going private to pay higher interest rates and agree to more lender-friendly contract terms. If the recent bout of volatility proves to be the beginning of a more drastic reduction in the availability of credit, bankers say, the days of the record merger run could be numbered." *WSJ; 7/2/07*

None the less, the Dow Jones Industrial Average reversed course from the previous quarter and ended the second quarter up 8.5%, or 7.6% year to date. The broader S&P 500-stock index was up 5.8% for the quarter (6% YTD), while the tech-stock-focused Nasdaq Composite Index ended the quarter up 7.5% (7.8%YTD) and the small-stock Russell 2000 index, showing signs of a cooling trend, gained 4.1% for the quarter and 5.8% at the mid year mark.

Absent the "deal du jour" impetus, the traditional fuel for stock market advances are corporate profits that can be recycled into further business investment or shareholder payouts, most often in the form of dividends. On this front the first quarter of 2007 seems to indicate a turning point in recent trends:

> *"While the U.S. economy slowed to 0.7% in the first quarter, earning growth at S&P 500 companies came in at 7.9%....this ended a record breaking streak of 14 quarters of double digit earnings growth above 10%...Second quarter earnings growth is so far expected to fall further to 4.3%..."* *MarketWatch; 6/29/07*

Faced with a slowing economy at home, as well as the resulting decline in profits, companies and investors will need to place more chips on global growth for additional revenues and investment gains. This will require exposure on the domestic front to multinational companies deriving a significant portion of their revenues in non-dollar currencies, as well as direct investments in foreign corporations.

> *"Many emerging markets were on a tear after a global first-quarter selloff. In late February, many benchmark indexes fell between 3% and 7% in a day and developing markets were hit hard after a nearly 9% drop in China's Shanghai Composite Index. In the second quarter, most emerging markets shrugged off an 8% one-day decline in the Shanghai index in June…The Dow Jones World Emerging Markets Index jumped 15% in the second quarter, compared with a 4.2% rise in the first three months…Global expansion continues to be driven by healthy economies and strong corporate earnings. Corporate profits continue to be strong in European countries like Germany, and have beaten analyst expectations in major Asian countries. Inflation -- which is usually a big worry in emerging markets -- has remained under control."* *WSJ; 7/2/07*

Although the developed world was a bit more muted, European bourses continued to advance in the 2nd quarter, with Germany leading the pack as Frankfurt's DAX jumped 16% in the quarter, and is now up 20.9% year to date. London's FTSE-100 added 4.8% (6.2% YTD) and the Paris CAC-40 advanced 7.5%, hitting the mid year mark up 9.2%. Tokyo's Nikkei 225 rebounded from the Shanghai tremors in the first quarter, adding 4.9% to finish the first half of the year up 5.3%.

As investors rather than traders, we focus on identifying value over the longer term, rather than assuming the risk of chasing an extended market with troubling valuations. We continue to evaluate opportunities domestically, but 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.

BOND MARKET OVERVIEW INVESTMENT POLICY COMMITTEE

Déjà Vu All Over Again…

The second quarter of 2007 once again focused its primary attention on the short end of the yield curve, watching the monthly F.O.M.C. meetings for hints of interest rate direction in the tea leaves of their commentary. The Fed chose not to move any of the chips on the table, standing pat at the June meeting for the twelfth consecutive month, after stopping it run of 17 straight quarter point increases at the meeting *last* June. Although the Fed Funds rate remained at 5.25%, the tradable portion of the yield curve turned modestly positive with the 2 year note closing the quarter at 4.87%, the 10 year at 5.03% and the less influential 30 year bond settling at 5.12%.

With the 10-year yield in the lower third of its 4.90%-5.30% trading range, the condition of the domestic economy and perceived risks from the subprime mortgage market fall out continued to impact the bond market.

> *"Meanwhile, the troubles in the subprime-mortgage sector continue to hang over markets, with investors trying to figure out what the consequences will be for the financial system, the U.S. economy and asset prices…For Treasurys, these two forces suggest a classic tug of war. The solid economy means hopes of a Federal Reserve rate cut remain somewhat remote -- a factor that has pressured government bond prices lower, lifting yields during the past couple of months. Yet with investors watching nervously to see what will happen next in the subprime story, there's every chance of further buying of government bonds by investors seeking relative safety."*
> *Wall Street Journal; 7/2/2007*

Domestic gross domestic product grew at an anemic 0.7% in the first quarter, down from Q406's 2.5% and last years overall growth rate of 3.3%. Expectations for the 2nd quarter GDP have risen as a result of the improvement in our exports and a rise in business investment resulting from a draw down of inventories. The Q207 number ranges from 3.5%-4.0%, with the initial release scheduled for late July, while the balance of the year is expected to be a more muted 2.6% to 2.9%.

Absent more rapid expansion of our economy, and in light of the afore mentioned potential spill over effects from the housing and sub prime mortgage challenges, the concern will be if this less than robust growth can sustain current rates of employment. Irrespective of the questions surrounding the inclusiveness or accuracy of the government's method of measuring the overall work force, the issues of consumer confidence and consumer spending will continue to be paramount for the condition of the economy. The April and May unemployment rates were 4.5%, fairly steady over the last year from last May's 4.6% rate. Given that consumer spending represents approximately two thirds of our GDP, a weakening housing market (both in house values and within the building and related industries) will have a negative wealth effect and could reign in the spending boom we've seen over the last several years.

> *"What Economy.com calls "active" Mortgage Equity Withdrawal (MEW), or loans that are either cash-out financing or home equity borrowing, is down almost 50% in the first quarter of this year from the last quarter of 2005. With rates increasing and lending standards being tightened, we can expect MEWs to fall even further, providing a drag on consumer spending growth, especially retail sales minus energy costs."* *John Mauldin; 6/23/07*

Additionally, the headwinds from rising interest rates could prove to be a drag as well, increasing costs for both consumers and businesses alike. The Fed continues to focus on inflationary pressures with its interest rates policies, which are primarily coming from rising energy and food prices, as well as the import impact of a weakening dollar. With global growth exceeding our domestic expansion, global rates are rising and attracting capital at the expense of the dollar. This causes the relative cost of our imports to rise in dollar terms, thereby inflating absolute costs and prices for goods and services purchased domestically.

On June 6th, the European Central Bank raised rates from 3.75% to 4%, while in May the Bank of England raised its benchmark another 25 basis points to 5.5%, with an indication that they will go higher. This dynamic puts pressure on our currency and can contribute to our inflationary environment.

The May CPI came in at 2.7% (April was 2.6%) with the Core CPI (excluding food and energy) at 2.2%, the same as in the preceding month. Despite the soothing words from Washington, we don't live in a "Core" world, and we all can attest to the impact that rising energy prices and food costs have had on our wallets and disposable income over the last several years.

As we've stated previously, given the challenges 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, both domestically and overseas, where we have the most flexibility in adapting to which ever set of circumstances prevails going forward.

WEALTH MANAGEMENT UPDATE — TRACY W. ROGERS

The Shoe Cobbler's Kid

An old saying I've been thinking about lately is the old saw "A shoe cobbler's kids go shoeless". Basically, it points out how difficult it is to keep one's own affairs in order when it is one's job to do so for others.

In the ***very*** recent past we enjoyed the birth of our third child. Of course, this means we should be re-evaluating our life insurance needs and updating estate documents. While we impress upon our clients the importance of evaluating life insurance needs periodically, we sometimes forget to do it on ourselves.

In my personal dealings with new clients this past quarter, it is very apparent that most people are too busy handling the day to day minutia of life, rather than increasing or decreasing their life insurance. This makes our job as an advisor all the more important. While I will be re-evaluating my family's needs for insurance, I thought this an opportune time to discuss who needs life insurance within different stages of life.

The Who

If someone depends on you financially, chances are you need life insurance. Life insurance provides cash to your family after your death. This cash (known as the death benefit) replaces your income and can help your family meet many important financial needs like daily living expenses, mortgage payments and college savings.

Most Americans need life insurance. To figure out if you need life insurance, you need to think through the worst-case scenario. If you died tomorrow, how would your loved ones fare financially?

Would they have the money to pay for your final expenses (e.g., funeral costs, medical bills, taxes, debts, lawyers' fees, etc.)? Would they be able to meet ongoing living expenses like the rent or mortgage, food, clothing, transportation costs, healthcare, etc? What about long-range financial goals? Without your contribution to the household, would your surviving spouse be able to save enough money to put the kids through college or retire comfortably?
The truth is, it's always a struggle when you lose someone you love. But emotional struggles don't need to be compounded by financial difficulties. Life insurance helps make sure that the people you care about will be provided for financially, even if you're not there to care for them yourself.

The Stages

You're Married
Most families depend on two incomes to make ends meet. If you died suddenly, could your family maintain their standard of living on your spouse's income alone? Probably not. Life insurance makes sure that your plans for the future don't die when you do.

You're a Single Parent
As a single parent, you're the caregiver, breadwinner, cook, chauffeur, and so much more. Yet many single parents have no life insurance whatsoever, and many with coverage say they need more. With so much responsibility resting on your shoulders, you need to make doubly sure that you have enough life insurance to safeguard your children's financial future.

You're a Stay-At-Home Parent
Just because you don't earn a salary doesn't mean you don't make a financial contribution to your family. Childcare, transportation, cleaning, cooking and other household activities are all important tasks, the replacement value of which is often severely underestimated. Some surveys have estimated the value of these services at over $40,000 per year. Could your spouse afford to pay someone for these services? With life insurance, your family can afford to make the choice that best preserves their quality of life.

Your Kids Are Self-supporting and Your Mortgage is Paid Off
As the years go by, you may feel your need for life insurance has passed. But just because the kids are through college and the mortgage is paid off doesn't necessarily mean that Social Security and your savings will take care of whatever lies ahead. If you died today, your spouse will still be faced with daily living expenses. What if your spouse outlives you by 10, or even 30 years, which is certainly possible today. Would your financial plan, without life insurance, enable your spouse to maintain the lifestyle you worked so hard to achieve? Would you be able to pass on something to your children or grandchildren?

You're Retired
Did you know that depending on the size of your estate, your heirs could be hit with a large estate tax payment after you die (up to 48% of your estate depending on your state). The proceeds of a life insurance policy are payable immediately, allowing heirs to take care of estate taxes, funeral costs, and other debts without having to hastily liquidate other assets, often at a fraction of their true value. And life insurance proceeds are generally income tax free and can be arranged to avoid probate. Finally, if your insurance program is properly structured, the proceeds from your life insurance policy won't add to your estate tax liability.

You're a Small Business Owner
Besides taking care of your family, life insurance can also protect your business. What would happen to your business if you, one of your fellow owners, or perhaps a key employee, died tomorrow? Life insurance can help in a number of ways. For instance, a life insurance policy can be structured to fund a "buy-sell" agreement. This would ensure that the remaining business owners have the funds to buy the company interests of a deceased owner at a previously agreed upon price. That way, the owners get the business and the family gets the money. To protect a business in case of the death of a key employee, "key person insurance," payable to the company, provides the owners with the financial flexibility needed to either hire a replacement or work out an alternative arrangement.

You're Single
Most single people don't need life insurance because no one depends on them financially. But there are exceptions. For instance, some single people provide financial support for aging parents or siblings. Others may be carrying significant debt that they wouldn't want to pass on to family members who survives them.

If you're in any of these types of situations, you should own life insurance because you wouldn't want your loved ones to be burdened financially in the event of your premature death. The kind of life insurance and the amount needed are evaluated through planning with our clients and a risk management professional. IMCG does not sell these vehicles but helps evaluate and coordinate the procurement of these products through other professionals. If anything has changed in your life and we need to re-evaluate, please let us help.

INSIDE THE MARKETS — FRANCIS J. DAVIES III

Taking the Mystery out of Hedge Funds…

The last few years have brought an explosion in the number and size of hedge funds. They seem to be everywhere buying everything – companies, currencies, bonds, even subprime housing loans. Several of the larger fund companies have recently offered shares to the public. Hedge funds as well as private equity funds control enormous amounts of money and have a significant impact on valuations in today's marketplace. This is the 'premium' built into the markets. Let's first look at hedge funds.

'Hedge fund' is a term that is applied to investment vehicles that share three elements:

1. They use a variety of long and short (or hedge) positions, normally combined with leverage.
2. They are a partnership structure where the general partner/fund manager is paid a percentage of profits.
3. They have a small number of limited partners as investors.

In 1949, Alfred Jones came up with the strategy of using hedging within an investment fund. He bought a security that he felt was relatively under-priced and combined this with the short sale of a security that he deemed over-priced. His goal was to create a "market neutral" fund; one that would not be influenced by movements of the market as a whole, only by the relative performance of the under-priced security to the hedge.

Jones also used leverage. This borrowing amplified the potential returns and also increased the risk. Jones' most clever wrinkle was his avoidance of SEC oversight. The fund was only sold to 99 accredited investors within a limited partnership format. By doing this, his fund was deemed a private offering to sophisticated investors who did not need supervision. These limited partnerships do not have to report their holdings. And their managers are allowed to take a performance fee. Jones chose to take 20 percent of profits as compensation.

That was the starting point, but hedge funds have changed greatly over the years. The only remaining common thread is the limited partnership structure. Many funds do not use any hedging. Most focus on investments other than stocks. Financial derivatives and synthetics are also a favorite, as is high yield debt. Since yield increases along with risk, high yield comes with high risk of default. When combined with leverage, the risk expands geometrically.

As the second quarter ends, the reality of this risk was driven home by the near collapse of two hedge funds that invest in subprime mortgages. The funds, both of which are run by Bear Stearns, carry the impressive, if misleading, titles of 'High Grade Structured Credit Strategies Enhanced Leverage Fund' and 'High Grade Structured Credit Strategies Fund'. Obviously someone was confused at Bear Stearns when they labeled a subprime fund as 'High Grade'.

During the recent housing boom, record volumes of mortgages were made, many to people that had no business borrowing the money. These loans were then packaged into bonds. The Bear Stearns funds own more than $20 billion worth of bonds backed by subprime mortgages. With roughly 13% of subprime loans in or near foreclosure, the value of the bonds imploded. As Bear Stearns tried to work on a plan to save the funds, Merrill Lynch, one of the hedge funds' lenders, seized some bonds and sold them to protect their investment. Bear Stearns eventually had to step in and loan the funds enough money to stay afloat.

It seemed that Merrill was still mad at Bear over another hedge fund fiasco. In 1998, Long Term Capital Management, an enormous hedge fund, collapsed. The Federal Reserve had to organize a temporary rescue. A bailout was organized by Merrill Lynch and included all of the major brokerage firms except for Bear Stearns. At the last moment, Bear declined to participate in the rescue fund, a move which came back to haunt them 10 years later. As you may have heard, there is no shortage of ego on Wall Street.

Hedge funds are now offering stock to the investing public. Not in their investment pools, but in the companies themselves. Hedge fund managers like Henry Kravis and T. Boone Pickens have consistently derided the inefficiency of public ownership. This was the logic behind the take over booms. The big concept was a hedge fund would buy a public company and take it private, install new management and improve operations, streamline expenses and make them more profitable.

Fortress Investment Group was the first hedge fund to sell shares almost six months ago. Then Blackstone went public on June 22, raising $4.75 billion. GLG Partners, one of Europe's biggest hedge funds, has said it would pursue becoming publicly traded in the US. Och-Ziff Capital Management, a $26.8 billion hedge fund has filed for an initial public offering. All of which set the stage for the most recent announcement. KKR, the leveraged buyout firm that made history for its $25.1 billion purchase of RJR Nabisco (read Barbarians at the Gate for the entire fascinating story) filed with the SEC its intent to raise as much as $1.25 billion in an initial public offering.

These firms made billions for themselves and their investors by knowing when to buy and when to sell. The smartest brains on Wall Street are selling shares in their own firms. They would not be cashing out if they thought they could get a better price in the foreseeable future. Just something to consider when deciding how aggressive you wish to be in the markets. Benjamin Graham (the man who taught Warren Buffet about investing) said *"The chief losses to investors come from the purchase of low-quality securities at times of favorable conditions."* In other words, do not stretch for returns by lowering your standards - advice the mortgage business needed a year ago.

IMCG NEWS

FRANCIS J. "TERRY" DAVIES III: Has recently completed the initial level in the four part process to become a Certified Divorce Financial Analyst. The Institute for Divorce Financial Analysts™ (IDFA™) is the premier national organization dedicated to the certification, education and promotion of the use of financial professionals in the divorce arena.

TRAVIS SPENCER: We are pleased to announce that Travis, returning to Maine with his family after two years in Vermont, has joined our *Client Development & Support Group.* He comes to us with previous experience in the mutual fund and retirement plan industries, including client support in financial services. The firm looks forward to adding his talents and perspective to the team's efforts as a *Client Service Associate.*

RUSSELL J. NEALEY JR.: After spending 14 years in the Navy as an instructor, supervisor and Command Financial Specialist, Russ and his family have returned to Maine. He becomes our most recent intern in the program we've run over the last ten years with USM's Business School. Given his background, Russ is being exposed to all aspects of the business, but will focus his time in the client support and research arenas.

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