INVESTMENT MANAGEMENT & CONSULTING GROUP

VIEWPOINTS

3RD QUARTER 2007 | ADVISORY NEWSLETTER

MARKET COMMENTARY FREDRIC W. WILLIAMS

Be Careful What You Ask For…

On September 18, investors finally got what they wanted when the Federal Reserve lowered its target interest rate, the Federal Funds rate, by a half-point. This followed a cut in the discount rate taken in August. The aggressive action prompted a surge in the market averages as the quarter drew to a close. The popular spin from Wall Street's talking heads was that this was just the tonic that the markets, particularly the bond market, needed. Judging by the burst of potentially irrational market exuberance that followed the cut, this seems a fair conclusion.

It is worth noting that: (1) the Fed had not changed interest rates since June 29, 2006, when it raised rates for the 17th consecutive time, completing a series of rate hikes spread over the course of almost two and a half years; and (2) the last time the Fed had lowered rates was back in June 2003. But, what may prove more important over the long run are the underlying reasons why the F.O.M.C would decide that this was the time to significantly cut rates. One would have to assume that Bernanke & Co. would not contradict its inflation fighting Fed-speak and reduce rates if they believed the domestic economy was cruising along just fine. Obviously they were concerned that the credit crunch, as well as some of the economy's underlying fundamentals, needed a bit of assistance.

As we've talked about in the past, the continued weakness in housing was beginning to show up in the consumer sentiment numbers. Since consumer activity represents about two-thirds of the nation's GDP, any reining in of spending or borrowing by John and Jane Mainstreet would not have a positive effect on the economy. We all remember the last round of "negative wealth effect" which occurred after the tech bubble burst in 2001. This experience taught many unfortunate investors that portfolios concentrated in technology stocks could actually decline in value, an insight that caused consumers to reduce spending and helped lead to the 2002 recession.

We do not wish to beat an already expiring equine, but housing is a crucial indicator of future economic activity and can alert us to coming developments with our gross domestic product. Given the collateral impact of the housing industry, from home builders to financing, fixtures and labor, the health of this sector has a significant spill over effect elsewhere in our economy.

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The problems lie in the knock-on effects that subprime is having and will continue to have on the economy. Jeffrey Gundlach of TCW Group asserts that the mortgage-triggered housing downturn has already cost GDP about one and half percentage points of growth. That negative impact figures to intensify some in the quarters ahead. Increasing defaults and foreclosures will add to an already swollen inventory of unsold homes that now stands by some reckonings at 10 months…August numbers showed, new home sales are continuing their descent, falling over 20% year-over-year. Barron's 10/1/07

The litany of bad numbers starts with building on the front end and runs through sales on the back side. August housing starts were down 2.6% to the lowest level since 1995, while building permits dropped 5.9%, again to a level not seen in 12 years. In the more focused sector of single family home starts, August plummeted by 7.1% to a 14-year low. Over the past year, starts are down 19.1% and permits by 24.5%, not exactly a picture of robust health.

New home sales were down 8.3% in August (off 21.2% in the last year) to a 7-year low, the median sales prices declined 7.5%, the largest monthly drop in 37 years. The inventory of unsold new homes increased to 8.2 months of "normalized" sales – a number we expect to see increase as the days of instant turnover become distant memories as fewer buyers find more challenges securing financing.

Existing home sales dropped 4.3% last month to a 5-year low. The S&P/Case-Shiller price index, which covers 20 metropolitan areas, was off 3.9% in August, the largest decline since the 1990-91 recession. The August report also confirmed the huge inventory of unsold existing homes with a 10-month supply of homes on the market – the largest amount of available houses since May 1989.

The Fed's rate cuts have impacted the currency markets – lower interest rates in the U.S. make the dollar less attractive when compared to other reserve currencies. The pound sterling has climbed to $2.033; the Euro fetches an all time high of $1.42 and the yen has surged with every dollar now worth only 115.12 yen. Although this will benefit US exports by making our products cheaper to overseas buyers, the more immediate impact is to the aforementioned Mr. & Mrs. Mainstreet. The consumer will face higher costs on all the products that are imported for their consumption. This is especially true in the oil market where the international transaction currency is the dollar. As the dollar weakens, the price of a barrel of oil is automatically pushed higher, making our energy costs higher and leaving less of the monthly budget for savings and other spending.

These varied conditions could come home to roost in the GDP numbers, as we've discussed in the past. Projected income growth will not offset the increasing costs of housing, energy and imported goods and the economy will slow. The GDP grew 3.8% in the 2nd quarter of 2007. Projections for the current quarter have fallen to 2.5%, while forecasts for the 4th quarter of 2007 reach as low as 1.5%. Given this potential trend line, it would appear that when the Fed pulled out the defibrillation paddles in an attempt to revive the economic pulse, it judged the patient to be closer to an ICU guest than a tri-athlete.

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These dynamics continue to support our cautious view of the future. We will continue to adhere to our moderate expectations that emphasize global diversification as a hedge against future dollar weakness, along with allocations to cash flow oriented assets. Our goal is still to generate real rates of return and mitigate volatility over the long term.

EQUITY MARKET OVERVIEW INVESTMENT POLICY COMMITTEE

Weathering the Storm…

The start of the 3^{rd} quarter of 2007 saw the domestic indices continue their momentum from the previous quarter, with the Dow closing for the first time about 14,000 on July 19^{th}. Amongst a raft of new developments this quarter, the return of volatility was one of the most obvious. The sub prime credit crisis began to unfold the day after the market hit 14,000. The flow of bad news eventually pushed the Dow down by 9%, with a close below 13,000 on August 16. The discount rate cut on August 17 restarted the rally and propelled the markets back towards the highs. It also provided investors with a multi-asset class roller coaster ride not seen for quite some time.

Despite the global credit freeze caused by the meltdown of the U.S. mortgage market, the domestic markets were able to continue their advance in the third quarter. The Dow Jones Industrial Average rose 3.6% and is now up 11.5% year to date - highlighting the advantages for large multinational companies with significant overseas revenues that can be repatriated into healthy earnings increases. The broader S&P 500-stock index inched up 1.5% for the quarter (7.6% YTD), while the tech-stock-focused Nasdaq Composite Index ended the quarter up 3.8% (12% YTD) and the small-stock Russell 2000 index, continued its cooling trend, actually dropping 3.4% for the quarter and leaving it ahead by only 2.3% for 2007.

Although not yet fully reflected in the domestic indices, the August credit crunch accelerated the evaporative rate of the merger and acquisition liquidity punch bowl, a dynamic that resulted in some deals beginning to get pulled from the market and could indicate an abatement in the "deal du jour" mentality that drove the markets higher over the last couple of years.

> *Public corporations and private buyers hatched some $562 billion of transactions world-wide during July, Thomson Financial said. That slid precipitously to $204 billion in August and an even scantier $192 billion in September, for a total $958 billion in the quarter. The drop-off in the world's leading M&A marketplace -- the U.S. -- was even more severe, with $52.8 billion in deals in September, about one-fifth to one-third of monthly volumes earlier in the year.* WSJ 10/1/07

Viewed another way, the equity markets may be facing a "borrowing binge" hangover similar to the one the overleveraged housing market is reeling under. Without a supply of cheap financing, the mathematics of acquiring appreciating assets is no longer simple.

Leverage, without which the only billionaires in these parts would be Bill Gates and Warren Buffett, became something to be leery of rather than to pile on. Indeed, borrowing as the path to riches seemingly overnight lost a heap of its cachet. In doleful consequence, the great merger-and-acquisition boom that supplied so much of the oxygen that kept high-flying equity markets aloft began to lose some of its incredible pizzazz. According to Dealogic, which keeps close tabs on such things, between the second and third quarters the global volume of deals shrank precipitously, by over 40%, to not quite $1 trillion. A. Abelson; Barron's 10/1/07

The overseas equity markets were significant laggards for the first time in quite some time, leaving them behind domestic for the year and presenting some interesting opportunities. The developed world's bourses experienced across the board declines as London's FTSE-100 dropped 2.1% (ahead 4% for the year), France's CAC-40 shedding 5.6% (now up only 3.1% YTD), while Frankfurt's DAX eased back 1.8% (still up an impressive 19.2% thus far in 2007). Much like the 8% YTD jump in the Euro versus the dollar hampered some European economies, the 7% surge in the yen caused many institutions to unwind their carry trades, pushing Tokyo's Nikkei down 7.5% for the quarter and leaving it underwater by 2.6% for the year. The silver lining in this cloud is that Euroland is now trading at about 12 times earning, compared to the 16-17 multiple found in the U.S.

Given that the media likes round numbers and anniversaries, we thought that sharing with you some well written observations regarding the 20th anniversary of the 1987 stock market crash might be a good way to provide perspective as we move into the last quarter of the year.

...the market has cooperated in this commemorative outpouring by exhibiting several of the elements that were present in '87, which will make things all too tempting for the fear mongers to draw parallels.
Let's see, '87 was also the fifth year of a bull market. It was the penultimate year of a two-term Republican presidency. There was relentless pressure on the U.S. dollar, and growing tension over trade with an ascendant Asian economic power.
The run to new all-time highs in the summer of '87 was accompanied by increasingly fervid leveraged-buyout activity enabled by pliant debt markets. There was a nasty sell off in summer, followed by a sizable recovery into early October.
So, the echoes are clear, and already some advisory services and blogs are amplifying them as the script for something similar happening soon.
Yet, the differences between then and now are at least as stark. Crucially, stocks are cheaper today than they were then (18-times trailing earnings for the S&P 500 now versus 22-times then), and interest rates are a whole lot lower.

In 1987, the S&P 500 at one point in August was up 45% for the year to date and all the way up stocks essentially had ignored Treasury yields as they ran from 7% to 9%, before faltering as rates neared 10%. Yet this year, the maximum year-to-date S&P 500 gain was 10% and Treasury yields simply moving toward 5% in late winter got investors' notice and seemed to thwart stocks' rally.

One thing we didn't have in 1987 was the vivid memory among so many players of a 22% one-day loss that had occurred within their career spans. That's a plus.

Drawing distinctions between '07 and '87 is not the same as saying we lack for risks today...Valuations are back near levels where, in this bull market, buyers' enthusiasm has waned a bit. It's unclear, too, how the market will digest the recent climb at the start of a new quarter.

And just because so many traders are expecting...a pullback, it doesn't mean one won't arrive before long, as sellers seize on some tidy excuse, like a prominent earnings preannouncement, an eruption from credit land or a reversal in the…Chinese stock market. M. Santoli, Barron's 10/1/07

Although we don't believe that history repeats itself, we do believe in the sage advice that you "ignore it at your peril" since it does provide a reference point for certain elements of a comparative analysis. As Mark Twain put it, "The past does not repeat itself, but it rhymes."

BOND MARKET OVERVIEW — INVESTMENT POLICY COMMITTEE

What Goes Up Must Come Down… (at least temporarily)

As detailed above, the 3rd quarter of 2007 marked the first time in more than 2 years that the F.O.M.C. reduced short term interest rates. On August 18th the Fed responded to the freeze in parts of the U.S. credit markets by cutting the discount rate (the rate at which the Federal Reserve will lend money to banks) from 6.25% to 5.75%.

The subprime contagion had spread from the mortgage market to other aspects of the bond market, in particular the asset backed securities and commercial paper arenas, with buyers pulling back from the market. Their fear was that they might unwittingly acquire subprime debt via asset backed structures or that they might be purchasing the unsecured debt of a compromised issuer in the commercial paper market. This resulted in various parts of the bond market grinding to a halt, threatening a number of deals, a large swath of the mortgage market and the ability of many corporations to roll over their short term financing needs.

The Fed followed this move exactly one month later with a more significant cut of 50 basis points in the Fed funds rate, along with an additional 50 basis point reduction in the discount rate, prompting a more than 2.5% jump in the Dow, along with a more muted response from the inflation-fearing bond market. At the end of the quarter the 2 year Treasury note yielded 3.96% (down from 4.87% at the end of the 2nd quarter), the 10 year was at 4.579% (down from 5.034%) and the 30 year bond closed at 4.84%, versus 5.12% at the end of the previous quarter.

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The lowering and steepening of the yield curve was emblematic of the disconnect in the credit markets during the 3rd quarter as it wrestled with one of the more severe credit crunches in quite some time.

> *"The government bond market had a relatively quiet and winning period last week, where the biggest event was what's known as a steepening of the yield curve, which meant that spreads between the two-year and 10-year note moved apart, largely as an ongoing adjustment to the Fed's rate cut.*
> *Meanwhile, the commercial paper market, where corporations go to score short-term funding, continues to shrink, largely due to a big pullback in asset-backed commercial paper issuance. Fed data last week noted that if not for a $17.3 billion drop in asset-backed CP, the outstanding level of commercial paper would have actually risen by $6 billion. And the elevated levels of the London Interbank offered rate, or Libor, show that global short-term financial conditions remain tender." M. Derby, Barron's 10/1/07*

What unfolds going forward may have a great deal to do with the aforementioned dynamics in the currency markets, which in turn will be dependent on the relative direction of respective sovereign yield curves. Any increase in overseas rates will exacerbate the downward pressure on the dollar as investment demand migrates to higher yielding currencies of similar quality. The focus here has been on the Bank of England and the European Central Bank given that Eurozone inflation concerns have begun to heat up. The September year-over-year number is expected to be 2.1% higher, while the August figure was up 1.7%. The ECB pushed raised rates to 4% in June, while the BOE bumped their gilt rates up to 5.75% in July - any additional rate increases across the pond will further erode the already weak dollar.

Given the ongoing turmoil in the bond market, as well as the continuing concerns about the impact that the weakening housing market will have on the domestic economy, 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 to take advantage of opportunities that present themselves going forward.

WEALTH MANAGEMENT UPDATE — TRACY W. ROGERS

Reverse Mortgages

"House rich, cash poor" is an old adage that may soon describe millions of Americans who have paid off their mortgages and yet are facing retirement with limited sources of income. One could have a whole discussion on whether or not paying down a mortgage versus investing is the best thing to do, but that is always a case by case basis. For a lot of retirees that find themselves living in their biggest asset, the concept of a reverse mortgage has now made this asset somewhat liquid. Given the current housing decline and mortgage meltdown, we thought this an opportune time to discuss this relatively new strategy.

How It Works

A reverse mortgage is simply a home loan that does not have to be paid back, as long as the owner continues living in the home. The amount a borrower can receive from a reverse mortgage is based on age, home value, the location of the home, and the cost of the loan. Generally, a borrower can obtain about 50% of the home's value through a reverse mortgage. Income from a reverse mortgage can be received in one of three ways: as a lump sum, as a series of monthly payments, or as a line of credit that would allow recipients to withdraw funds at any time.

The majority of reverse mortgages are Home Equity Conversion Mortgages (HECMs), which are insured by the Federal Housing Administration (FHA). This type of reverse mortgage ensures that the borrower will receive the amount specified in the contract and will not have to pay back more than the home's value at the conclusion of the mortgage, even if the loan amount exceeds the home's value. The FHA sets limits on the amount a borrower can receive. Limits range from $200,160 to $362,790, depending on the geographical area.

Three Main Requirements

There are three main requirements for obtaining a reverse mortgage: (1) the owner or owners must be 62 years of age or older; (2) the home must be the owner's principal residence; and (3) the owner must own the home outright or be able to pay off any existing mortgage with funds from the reverse mortgage. If the owner's equity is less than half of the home's value, then a reverse mortgage may not be appropriate.

The Owner Remains the Owner

With a reverse mortgage, the owner continues to possess the home's title and is not required to pay back the loan as long as he or she is still living in the home. Even if the loan balance eventually exceeds the property's value, the owner will not be forced to sell or move. The lender does not take ownership of the home at any time.

The Cost

Many people are hesitant to reverse mortgage their homes because of the high costs often associated with this type of loan. Although closing costs are a bit higher than for a traditional home loan, they are not as high as many people expect.

All fees associated with a reverse mortgage are subject to HECM limits. The interest rate charged on a reverse mortgage equals the one-year U.S. Treasury security rate plus the lender's margin and the insurance premium. The cost of fees and interest can be financed into the loan so the borrower never has to pay for charges out-of-pocket. Additionally, any funds received through a reverse mortgage are tax free—a perk that may offset some of the costs.

Options for Heirs

A reverse mortgage does not need to be repaid until the owner either moves out of the house or dies. Some people may be worried that a reverse mortgage would saddle their heirs with debt, but there is an array of options for repaying the debt and heirs cannot be required to pay any money out-of-pocket unless they choose to do so.

One option is to simply sell the house and use the proceeds to pay off the loan (remember that the repayment amount can never exceed the house's market value). If the selling price is more than the reverse mortgage balance, the heirs can usually pocket the difference. If the heirs are unwilling to part with the house, they can pay off the reverse mortgage either with their own funds or by obtaining a new mortgage.

Of course the flipside is that, in many cases, the reverse mortgage will consume the entire value of the house and heirs will not inherit any of its value, so next quarter we will discuss the appropriateness, or lack thereof, of this strategy to various sets of circumstances.

INSIDE THE MARKETS FRANCIS J. DAVIES III

Separating the Wheat from the Chaff….

The truth about investing — the stock market, bonds, investment returns, risk, volatility — is a complicated, nuanced reality. We discuss this fact with our clients at every chance. We want you to know that the process is more complex than the warm and fuzzy world found in the advertising of our competitors. Like everything else in the real world, there are no easy answers. There are also inherent contradictions in the markets, requiring that one must hold conflicting ideas simultaneously.

Obviously, TV commercials are not reality. On the other hand, investing can get very real because it entails very real risk. An opportunity for profit does not come without a chance of loss. The type of investing we do at IMCG requires managing the balance of risk vs. reward. That means we must look at what could go wrong, the downside of an investment, as well as the upside. This topic is covered extensively in these quarterly letters to our clientele. We are trying to be depressing – just prepared.

The recent debacle within the credit markets was foreseen in these pages and portfolios were adjusted ahead of time to account for the increased risk. The issue was one of too much money chasing too few decent investments. Warren Buffett wrote about this in 2000:

> *The line separating investment and speculation, which is never bright and clear, becomes blurred still further when most market participants have recently enjoyed triumphs. Nothing sedates rationality like large doses of effortless money. After a heady experience of that kind, normally sensible people drift into behavior akin to that of Cinderella at the ball. They know that overstaying the festivities -- that is, continuing to speculate in companies that have gigantic valuations relative to the cash they are likely to generate in the future -- will eventually bring on pumpkins and mice. But they nevertheless hate to miss a single minute of what is one helluva party. Therefore, the giddy participants all plan to leave just seconds before midnight. There's a problem, though: They are dancing in a room in which the clocks have no hands.*

Warren Buffett has produced incredible returns in the stock market over the past 40 years by following a strict value discipline. This means he buys cheap and sells dear. It is all about the steak with him, not the sizzle; fact not emotion. A philosophy dear to our hearts.

Buffett owes much of his success to his mentor, Benjamin Graham, who died in 1976 and was a finance professor at Columbia in addition to being an all-world investor. Graham was the greatest investment mind of the 20th century and the author of the best investment book written, "The Intelligent Investor", in which he said "Operations for profit should be based not on optimism but on arithmetic."

Meaning: Arithmetic is easy to quantify. Optimism is not.

An example of optimism: "Stocks always go up in the long run."

The corresponding arithmetic: Stocks go up in the long run but they also go down. The 1920s Bull Market gained 340%. All of which was then surrendered. The Bull Market that started at the end of World War II and ended in 1966 also gained around 340%. And, all of that was given back.

See the contradictions? If it fits on a bumper sticker, it's wrong. Dig deeper into the facts.

There were plenty of people that were invested for some or all of those time periods that lost money. It is necessary to define "long run." It is also necessary to see where we are starting. For example, are equities cheap or expensive? Are interest rates rising or falling? Is the economy contracting or expanding?

According to Graham, "To have a true investment, there must be a true margin of safety. And a true margin of safety is one that can be demonstrated by figures, by persuasive reasoning, and by reference to a body of actual experience." Again: Experience or fact can be quantified. Opinion cannot.

An example of opinion: "Stocks do well when our economy does well."

The experience: From 1966 to 1982, the GDP grew 370%. During that time the return on the S&P 500 was zero; it was unchanged.

So the economy does not dictate return. Except when it does: From 1982 to 1999, the GDP grew 174%. During that time the return on the S&P 500 was 1,200%.

We keep it simple: buy cheap, sell dear. It is not easy, but it works.

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IMCG NEWS

FREDRIC W. WILLIAMS: At the recent Dream Factory Annual Convention in Atlanta September 14th to 16th, Fred was appointed to another term on the organization's Executive Board chairing the Finance Committee.

FRANCIS J. DAVIES, III: Terry has begun to write a financial column for SWITCH, a Portland paper. He has also been appointed to the planned giving committee of Preble Street, a homeless day shelter in Portland.

EVENTS OF INTEREST:

- **The Dream Club Speakeasy at Harbour's Edge** – A casino night to raise funds for the Dream Factory and its mission of granting dreams to the critically and chronically ill children of Maine. Thursday October 18th from 7:00 PM to Midnight at 6 Custom House Wharf – tickets and additional information can be found at www.dreamfactoryofmaine.org

- **The Margaret Mead Film and Video Festival** – October 11th, 12th and 13th in Portland. Additional information and tickets can be found at www.ctn4maine.org

- The AARP and the SEC are co-hosting a **"Wise and Safe Investing Conference"** October 9th from 9:30 AM to Noon at the Sable Oaks Marriott in South Portland. Registration is required and should be done through the Department of Professional and Financial Regulation's Augusta office at 877.926.8300.

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