



VIEWPOINTS

4TH QUARTER 2007

ADVISORY NEWSLETTER

MARKET COMMENTARY

FREDRIC W. WILLIAMS

A Tale of Two Halves...

It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity...

Charles Dickens – "A Tale of Two Cities"

For the financial markets, 2007 was also a time of opposing chapters. During the first six months, private equity buy-outs led markets towards new highs. In the second half, it was made clear that the annoying background noise was in fact air leaking out of the debt balloon. The breakdown of the credit markets was the result of shoddy loan issuance over the previous few years, something this newsletter discussed exactly one year ago. Although the Dow Industrials reached a new all time high in October, the major event of the second part of 2007 was the growing comprehension of the size of the credit crisis and the acknowledgment that the contagion's impact was yet to be fully quantified or appreciated.

"Investors are entering the new year tired and jittery, preoccupied by seized-up credit markets and building recession fears. In the autumn, many money managers adopted what some dubbed a "Tupperware" approach to all this: a hope that the financial markets' problems would be contained. But as housing woes and troubles with mortgage-backed securities spilled over into the broader credit markets and the economy in general, investor assurance began to wane." WSJ 01/02/08

Last quarter we cautioned "be careful what you ask for" as the market's ebullient response to the F.O.M.C.'s rate cuts overlooked the Fed's actual concerns – a weakening economy and a frozen credit market. The concern at this point centers on the extent to which rate reductions will have an impact in an environment where banks hesitate to lend to each other, to say nothing of the business and consumer markets. All the rate reductions on the planet will not soon heal the skepticism of market participants burned by losses in bonds which were sold as investment grade paper, but which turned out to be a failed experiment in financial alchemy. The assorted alphabet soup investments of CDOs and SIVs, which claimed to turn trash into treasure, proved to be swine with lip gloss once the housing bubble popped. It will take time to salve the wounds and get the markets working again – the best possible outcome being an increase in transparency in these structured investment products.

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As we cautioned last quarter, it was only a matter of time before these dynamics expressed themselves in other parts of the economy:

“Greeted by a jobs report (for December) that undershot already-pessimistic forecasts, traders should be invoking the Lily Tomlin line, “No matter how cynical you get, it’s impossible to keep up.” Now starts a three-week minefield of data-combing, Fed-handicapping and earnings reporting. Friday’s stock tumble and bond surge shows investors pleading for more-aggressive Fed action at the Jan. 29-30 meeting. If the Fed gives less than the market is asking for on the meeting date, it might be taken as a sign that policymakers are hamstrung by a weak dollar and inflation forces. Welcome to 2008.” Barron’s 1/7/08

It’s instructive at this point to recognize that the “everything is going to hell in a hand basket” bandwagon is starting to get crowded as the recessionary chorus grows louder with each release of weak economic figures. We would not suggest that we have reached the bottom or that a bottom can even be seen yet, but just as markets don’t go up forever (see private equity bubble, tech bubble, et. al.), neither do they go down forever. Many market participants allow their emotions to make linear extrapolations about the future, rather than recognize that cycles do exist and that volatility, although unsettling, creates opportunities for those with patience and a longer term view.

In this regard, we see the past as prologue, with the first part of 2008 resembling the weakness of the last part of 2007. But with a more accommodating interest rate environment and time to work through the housing/mortgage hangover, the credit markets will revive and allow us to look across the valley to improvements in 2009.

Since the markets are a telescope into the future, discounting events that may be 12 to 18 months away, it will be important to remain defensive through these challenging times, while still looking to uncover opportunities as the vagaries of the market present them.

EQUITY MARKET OVERVIEW

INVESTMENT POLICY COMMITTEE

The Evolving Storm...

Stock market investors were a manic bunch during the 4th quarter of 2007 as they picked their way through year end with one eye on the credit markets and the continuing subprime battlefield, while keeping the other eye trained on the economy and the dreaded “R” word. Despite the protestations of many Wall Street optimists to the contrary, the economy was slowing appreciably into December. The prospects of a constrained consumer combined with less than robust corporate earnings weighed on the outlook for near term appreciation in the indices.

“Fourth-quarter returns for the benchmarks stacked up as follows: The Dow fell 4.5%, the S&P 500 fell 3.8%, the Nasdaq fell 1.8%, and the Russell 2000 fell 4.9%. The decline broke a string of five straight quarterly gains for the S&P 500. It was the Dow’s first fourth-quarter loss in a decade.” Barron’s 1/7/08

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For the full year 2007, the Dow Industrials rose 6.4%, the S&P 500 was up a more modest 3.5%, the NASDAQ jumped 9.8% and the Russell 2000 eased off 2.7%, highlighting a volatile year with accompanying disparate returns. Of interest to our value oriented investment discipline was the 16.6% appreciation in the Dow Jones Utility Average, reinforcing the old saw that the tortoise can, in fact, beat the hare. Even more illustrative is the comparisons with the 3 year average returns for these widely followed barometers: the DJIA averaged a gain of 7.2%, the S&P 500 6.6%, the NASDAQ 6.8%, and the Russell 2000 5.5%...compared to the Dow Utility Average's stellar average return of 16.7%.

The domestic equity markets were fortunate to back out of 2007 in positive territory as 2008 got off to a rough start. During the holiday shortened first week of the New Year, the Dow was off 4.2%; the S&P 500 dropped 4.5%; the NASDAQ lost 6.3% and the Russell 2000 fell 6.5%. Thankfully New Year's Eve came *before* the painful first week of 2008 because measured from 1/1/07 to 1/4/08, the S&P 500 had a negative return while the Dow and NASDAQ had returns of less than 4% for the 53 week period.

As postulated in previous issues, absent the artificial air imparted by the private equity buyout pump, the domestic equity markets had to rely on the old standbys of revenues and profits to drive rising equity prices. Much like the end of the venture capital and "new paradigm" equity bubble of the late 1990s, the loss of this deal du jour exuberance will be a deflating influence over the near term. Additionally, with top line income at risk from a slowing economy and margins crimped by rising inflationary cost pressures, stock valuations during the 4th became more suspect – something which may continue as a dynamic into the first few quarters of 2008.

As the subprime contagion continued to circle the globe, its secondary effects were seen in the overseas markets which drifted lower during the last quarter of 2007. The developed world's bourses experienced across the board declines as London's FTSE-100 inched down 0.2% and was ahead 3.8% for the year; France's CAC-40 dropped 1.8% (up only 1.31% for the year) and Tokyo's Nikkei the big loser, off 8.5% for the quarter and 11.1% for the year as concerns about a global slowdown impacted its export centric economy. The big winner was Frankfurt's DAX, which added 3.1% for the quarter and an impressive 22.3% for the year.

The fireworks again this quarter were in the emerging markets with returns ranging from a "mere" 32% in South Korea's Kospi, to 43% in Brazil's Bovespa, 47% in Bombay's Sensex and a lights-out 165% in mainland China. Despite this, a rising consensus views Putin's "Man of the Year" designation as a potential top in the run that the emerging markets have enjoyed the last several years (to say nothing of the impact that a global slow down might have on these bourses). Similar to the market top observation that was heard when Blackrock and other private equity firms decided to go public earlier this year, the smart money sees these markets and companies to be priced for perfection, with downside surprises a more significant risk now than in the past.

We're thankful to a friend who responded to our equine analogy last quarter by positing "a homicidal act on the gilded gander producing a valuable spheroid" as an apt description of

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the risks in the gold and oil markets. Since the yellow metal has no appreciable manufacturing use, other than the weakening jewelry market, its attraction is merely as a contrarian index of misery. To be sure, the list of concerns, most significantly being the decline of the dollar, is not short, but the question is how long the entries on the list will remain negative. In a similar fashion, oil has a substantial terror premium, which is more than justified, and there is no doubt about the rising demand for this limited resource, but, as with gold, it appears that investment demand and a dollar hedge are pushing prices higher, rather than basic fundamentals.

BOND MARKET OVERVIEW

INVESTMENT POLICY COMMITTEE

Subprime Prime Time

Despite the F.O.M.C. reducing rates by 25 basis points in both the Fed funds target rate and at the discount window on November 11th and again after their December 12th meeting, the bond market was dominated during the 4th quarter of 2007 by the continuing impact that the subprime mortgage contagion was having throughout the global credit markets.

“The corporate-debt market unwittingly became a victim of contagion from the subprime-mortgage turmoil in 2007, as prices of many bonds and loans plunged even while corporate defaults remained very low...The subprime downturn severely hurt many large banks and Wall Street firms, which took billions of dollars in write-downs and losses on the mortgage-related securities they held. The ensuing liquidity crunch in the credit and money markets created problems for other financial institutions and lenders, which found it more difficult and costly to raise short-term debt needed to fund their operations.” WSJ -1/02/08

The inverted yield curve of early 2007 reflected the Fed’s moves on the short end and the markets concerns at the long end. Overall, we had a lowering and steepening of the yield curve as near term recessionary fears battled potential future inflationary pressures. This struggle was evident in various target rates at the end of 2007: the Fed funds rate closed the year at 4.25%, down 1% from a year earlier, while three month Treasuries traded at 3.25%, and one month LIBOR (London Interbank Offered Rate) was at a much higher 4.60%.

This mirrored the flight-to-quality tenor for the year, something which accelerated during the 3rd and 4th quarters, as investors flocked to the relative safety of domestic Treasuries.

“Spreads on below-investment-grade, or junk, bonds over Treasuries hit a record low of 2.4 percentage points in the middle of 2007, but in the past six months they widened to 5.92 percentage points, according to Merrill data. Junk bonds returned an anemic 2.2% in 2007, versus 11.8% in 2006, after factoring in their coupon payments and price changes. Leveraged loans, meanwhile, returned 2.1% in 2007, their lowest return in five years, according to S&P LCD...Last year's downturn in corporate and mortgage bonds helped Treasury securities, which benefited from a flight to quality by many investors. The yield on the benchmark 10-year Treasury note fell to 4.033% at the end of 2007 from 4.708% a year earlier as prices rose. Treasuries

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outperformed most other types of bonds, returning 9.1% in 2007, including price appreciation and interest, according to Merrill data.” WSJ 1/2/08

With private equity buy-outs and other deals grinding to a halt in the 3rd quarter, the bond market spent the bulk of Q4 in a holding pattern waiting for the other shoe to drop. With the subprime virus already infecting its way up the credit ratings ladder, investors anticipated additional impacts from asset backed securities being marked to market (instead of “model”) and the eroding impact of SIVs being brought on the balance sheets of an ever widening swath of the financial services industry.

With the major banks’ Super-SIV dying on the vine in December, the Federal Reserve, along with other central banks around the globe, stepped into the breach with a variety of liquidity injections programs aimed at getting more credit flowing in the financial system. Combined with increased activity at the Fed’s discount window (despite its sometime stigma), it was apparent how tight the markets had become:

“Banks leaped to take advantage of the Fed's auction, which was held on Monday, with 93 bidders submitting US\$61.6-billion in bids. Analysts had expected the interest rate to be somewhere between the overnight federal funds rate of 4.25% and the discount rate of 4.75%.

The Fed auctioned off the money as part of a coordinated move by central banks around the globe to thaw frozen credit markets.

Demand for the funds and how much banks were willing to pay offered a signal of how deep financial distress is and how important a role the Fed and other central banks can play in easing the strains.” National Post – Reuters; Toronto 12/19/07

As the 4th quarter drew to a close, the bond market was on recession-watch, with weak retail sales, consumer confidence and employment data being compounded by ongoing softening in housing and manufacturing. It appears that the credit markets will remain hostage to the near term economic weakness that calls for lower rates and the longer term inflationary pressures that a weaker dollar can “import” to the States through increasing product and services costs.

Since we expect the first half of 2008 to be weaker than the second, we look for opportunities that patient long term investors can benefit from as we make our way through what promises to be an eventful year. As always, there will be volatility that rational market participants can take advantage of, and 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 these evolving developments.

WEALTH MANAGEMENT UPDATE

TRACY W. ROGERS

Reverse Mortgages – Part Two

In last quarter’s newsletter we provided information on reverse mortgages, how they work, the requirements and other information. In this quarter’s we will discuss some of the pros and cons of this strategy as well as other possible solutions.

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The Cons

Costs

These types of loans have very high costs associated with them. Reverse mortgage lenders make money through interest, origination fees and points. The interest rate varies according to the market. However, closing costs are significantly higher with reverse mortgages.

Mortgage Insurance

Mortgage insurance guarantees the lender will receive its full repayment. For example, a decrease in the property's value adversely affects the lender's reimbursement. Mortgage insurance also covers the lender in the event the mortgage is held over a very long period of time and accrued interest exceeds the value of the home.

Medicaid

Depending on where you live, the proceeds from a reverse loan could prove a barrier to qualifying for Medicaid, which counts loan proceeds as an asset.

Prolonged Absence

The terms of many reverse mortgages knock homeowners out of their homes after a period of absence – like a prolonged, but temporary, nursing home visit – which varies from lender to lender. Some reverse mortgages require the full loan balance plus accrued interest be repaid when the house is vacated by the owner for this specified period of time.

Complexity

Reverse home mortgages are so complex and confusing that you are required to receive counseling before applying for one. The confusion is caused by there being three basic types of reverse mortgages: the HUD backed mortgage, the lender-insured mortgage, and the uninsured mortgage. The most popular is the Home Equity Conversion Mortgage, which is insured by the Federal Housing Administration.

The Pros

Tax Free

Since payments are considered a loan, they are tax-free.

No Restrictions

You can use the money for any purpose. Most people use the funds for home improvements, for in-home healthcare, and to pay taxes and insurance costs.

Guaranteed money

You are guaranteed a source of money for as long as you need it, no matter how long you live. In addition, no matter how much you wind up borrowing, you will never owe more than the house is worth when the loan is repaid.

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An Alternate Strategy

A more tax-effective strategy may be to set up a Home Line of Credit (HLOC), and draw income as needed, using some of the proceeds to make the minimum interest payments. As with any loan, the money received is tax-free. Since the drawings do not count as income, this strategy might reduce the clawback of government benefits, such as the Guaranteed Income Supplement.

This approach is much cheaper not just because the interest rate charged on a HLOC is typically prime – the lowest rate generally available – but you only pay interest on the amount borrowed and you have the flexibility to draw income as you need it. Note that any source of collateral can also be used to secure a line of credit, including investments and life insurance cash values. By using a life insurance policy to secure a line of credit, you may be able to have the interest payments deferred until death, as with a reverse mortgage. The downsides to drawing from a line of credit are that it cannot continue indefinitely, and if you draw too much, you could have to pay down the loan before you die – possibly forcing you to sell your home. For a price, a reverse mortgage solves these problems, allowing you to stay in your home forever without ever having to worry about payments, markets or interest rates.

As with many strategies, they are not right for all. If you are considering this, you should evaluate the pros and cons of each option very carefully before proceeding. We can help with referrals to professional colleagues to help in this matter as well as assist you.

INSIDE THE MARKETS

FRANCIS J. DAVIES III

Opportunity is missed by most people because it is dressed in overalls and looks like work.

~Thomas Edison

As we discussed in this space last quarter, investing is a complicated and sometimes contradictory duty. It demands that we ignore our heart and listen to our brain. Emotion leads to bad decisions – euphoria tries to keep us invested at market tops and despair makes us turn away when the markets are cheap and present opportunity. We are likely to confront despair as we face a recession in the coming year, so we need to plan for it.

“Sublime Sub Prime” was the headline of this market letter one year ago. The article correctly anticipated the damage that would result from the unwinding of the mortgage bubble. It was clear in January 2007, that the gains seen in real estate were unsustainable. Home values could not continue to rise 10% every year. After some failed attempts to slap band aids on the issue – the markets have finally begun to return to equilibrium. This is the inevitable result when supply overwhelms demand. The facts are startling.

New home sales fell 34% in November vs. a year ago, while existing home sales dropped 20%. At the current pace of sales, it will take another 9 months to clear out the inventory of new homes. Home prices are falling at an unprecedented rate. The October S&P/Case-Shiller Index of home prices dropped a record 6.7% from the previous year. For home sellers, the worse news is that the rate of decline is accelerating.

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Declining home prices shuts off a vital source of funds – home equity borrowing. In 2006, roughly 7% of disposable consumer income was drawn from housing value. The US consumer continued to borrow and spend past any reasonable point. The amount of debt is staggering. Credit card debt is at an all time high, home equity is tapped out and there are increasing delinquencies in both. Meanwhile the Gross Federal Debt tops \$9 trillion.

The housing market trouble has spread into non-housing areas. Lending standards have been tightened as a result of the crisis (known as closing the barn door after the cow is long gone) and credit has been squeezed. This credit fed the takeover boom of the last few years which kept a floor under stock prices. Borrowing by private equity firms totaled more than \$500 billion in 2007. Buy out funds accounted for \$200 billion and real estate was next at \$75 billion. The window for these loans began closing during 2007 as 59% of the funds were raised in the first half of the year alone.

Bill Gross, the managing director of PIMCO, a firm that manages \$720 billion in fixed income, thinks that the recession started in December. A recession is defined as 2 consecutive quarters of declining growth. The stock market averages a 28% decline during recessions. For strategic investors with cash in reserve, a drop in prices is a chance to buy asset classes on the cheap.

Buy low and sell high. It is never easy. But it is very rewarding.

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