VIEWPOINTS

1ST QUARTER 2008	ADVISORY NEWSLETTER

MARKET COMMENTARY FREDRIC W. WILLIAMS

The Shadow Knows…perhaps…

Over the last several months a great deal of smart print has been posted regarding the potential causative agents surrounding the financial challenges the markets have been facing. To be sure, there are likely a multitude of contributory factors, but of late more than one voice has raised the so called "shadow banking system", and its lack of oversight, as qualifying for the more-than-culpable category.

The investment banks, much more highly leveraged than their commercial siblings who fall under the supervision and reserve requirements of sovereign central banks, were able to propagate the alphabet soup of repackaged products (CDOs, CMOs, CLOs, etc) within which the wizards of Wall Street performed their financial alchemy and transformed questionable investments into something the rating agencies were mesmerized into stamping a tripe-A label on.

As the loans and collateral that populated these pools began have both repayment and valuation issues, the sub prime mortgage debacle morphed into a crisis of confidence that spread to all corners of the credit markets, effectively seizing up the access to funds that fuel the global economy. The declining market value of these investments hit the balance sheets of banks, investors and non-financial corporations, resulting in write downs and losses that have continued for the last 6 months, nearly completing a self fulfilling prophecy with the collapse of Bear Stearns in March of this year.

In light of Treasury Secretary Paulson's recent regulatory proposals, Bill Gross at PIMCO seemed somewhat prophetic when he commented:

> *"In my opinion, the private credit markets have forfeited their privileged right to operate relatively autonomously because of incompetence, excessive greed, and in minor instances, fraudulent activities. As a result, the deflating private market's balance sheet is being re-nationalized in some cases with increased regulation, in others with outright guarantees and agency lending."* *April 2008*

Still standing at the end of this series of events is the U.S. consumer, having been provided with a mortgage many couldn't afford without lower than normal "teaser" rates and/or overly

Post Office Box 4802 ♦ 97A Exchange Street ♦ Portland, Maine 04112
1771 Post Road East ♦ Westport, Connecticut 06880
207.774.6552 ♦ 800.605.6552 ♦ FAX 207.775.2969
www.imcgrp.com ♦ info@imcgrp.com

inflated appraisals. As the various adjustable rate mortgages were moved upward to real market rates, that coincided with the value of the collateral beginning to decline, as both the demand *and* supply side of the housing market pushed values back toward reality. Combine that with increasing costs of living (food, fuel, etc.) and it's easy to understand why the American Banker's Association for the *4th* quarter of 2007 showed that consumers fell behind on car, credit card and home equity loans at the highest level in 15 years…something that likely didn't *improve* during the first quarter of 2008.

The key to the consumer's kingdom is likely the stabilization in housing prices, such that the current oversupply can begin to be worked off, and troubled loans can be "cleared" (through either refinancings or foreclosures) by the market, thereby establishing a more realistic level off of which reasonable lending can resume. It's not going to be either easy or fun, but neither sometimes is the morning of January 1st.

Despite all this gloom, we harken back to a comment in this space from last quarter:

> *"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."*

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 markets present themselves.

EQUITY MARKET OVERVIEW — INVESTMENT POLICY COMMITTEE

What Goes Up…

As we had discussed last quarter, the global equity indices were fortunate to slip through the end of 2007 so they could post the numbers for the year in the black, given the weakness in both January and the rest of the first quarter of the new year. Any delusion that the credit crisis was going to be isolated to the sub-prime arena, or even just the debt markets, was dispelled as the expanding impact spread throughout the economy, culminating (thus far) with collapse of Bear Stearns and its purchase/bailout/rescue/steal by JP Morgan Chase.

> *"After its first-quarter decline, the Dow is down 13% from its record close of 14164.53, hit Oct. 9, 2007.*
> *The Standard & Poor's 500-stock index, which has a heavy weighting of financial stocks, took a bigger hit in the first quarter, losing 9.9% to 1322.70, and is down 16% from its October record.*

The Nasdaq Composite Index, which outperformed both the DJIA and the S&P 500 in 2007, lost 14% during the first quarter and is down 20% from its recent high in October. The Russell 2000 index of small-company stocks, which are seen as most vulnerable to a recession, is down 10% this year and has lost 20% from its most recent high." WSJ 04/01/08

As we discussed last year, the seizing up in the credit markets robbed the private equity groups of their fuel for M&A activity, removing a significant supporting prop for equity prices. Combine that with the re-emergence of investor fear (finally) and we saw a re-pricing of risk throughout the global equity markets. Much like the piercing of the tech bubble earlier this decade, it was only when the music stopped that the lemming-like trend investors started to realize the absence of rationally based "chairs" to hold their dollars. This has resulted in some bouts of near panic-like selling, greatly increasing the daily volatility within the domestic indices, and brought on more than a few bouts of vertigo during the quarter. The question of the day, however, is whether the tumultuous activity in the markets between the March 10th low and the Bear "acquisition", was a bottom or merely an intermediate stop on the down escalator.

"Although it is small comfort to investors toting up their losses for the first quarter, the Dow and the S&P 500 haven't reached the 20% peak-to-trough decline that is the traditional definition of a bear market. Both indexes hit their lows for the quarter in the days before the collapse of Bear Stearns, amid concerns that the entire financial system was in danger of seizing up. On March 10, the Dow closed down 17% from its October peak, and the S&P 500 finished down 18.6% from its high. Since then, the Dow has rebounded 5% and the S&P 500 has bounced 4%.
"If stocks don't pierce their March 10 lows, and if it turns out the U.S. economy is in a recession, it would be the first time since 1961 that an economic downturn isn't accompanied by an official bear market." WSJ 04/01/08

A potential downside of globalization has been the debunking (thus far) of the decoupling myth whereby foreign economies would somehow be insulated from the financial crisis in the U.S. Although the eventual magnitude of the overall impact will take more time to evaluate, the near term influence was clearly seen in bourses around the globe during 2008's first quarter. And much like we've seen repeatedly in the past, those markets and assets that have had the greatest prices movements to the upside, tend to preserve their beta on the downside as well.

"Some of last year's highflying markets, like India and China, have seen this year's worst drops, with shares in both countries down more than 20%. Japan's stock market, a laggard in 2007, fell deeper into the red, with the benchmark Nikkei Stock Average of 225 companies down 18%.
"The gloom has been equally intense in Europe, with benchmark indexes in the United Kingdom, Germany and France each falling more than 10%. Germany's DAX index had the biggest decline of the three, tumbling 19%. France's CAC 40 index dropped 16% and the U.K.'s FTSE 100 fell 12%.

> *"Such declines around the world illustrate how far-flung markets have become correlated. As global investors have expanded their range, they have deepened the connection between various markets. And when markets get more volatile -- as they have in the latest quarter -- they all tend to move in the same direction." WSJ 04/01/08*

Despite all this apparent market negativity, there are reasons to believe that prudent long term investors should be looking toward emerging opportunities for the balance of 2008.

> *"UP 400! DOWN 300! UP 260! TO many stock-market observers, especially those accustomed to the minimal price volatility of recent years, such dizzying swings in the Dow Jones Industrial Average might suggest stocks have lost their moorings and are headed sharply lower. History says otherwise, however, as huge volatility is associated with market bottoms, not tops. When volatility spikes to the levels seen recently -- levels that have prompted even the nightly news anchors to wag their heads in disbelief -- it is usually time to buy, not sell." R.W. Arms, Barron's 03/31/08*

Much like the late '90s, our valuation discipline compelled us to accumulate and increase cash positions in portfolios last year given our previously mentioned concerns about the economy and relative market fundamentals. After the first quarter of 2008 we are beginning to see initial signs of attractive valuations in the markets' retrenchment. Given the globally accommodative central banks, and their stated mission to thaw the credit markets, along with anticipatory nature of the equity markets, we believe that beginning to redeploy a portion of our cash positions over the next several quarters could serve prudent, and level headed, investors quite well in the future.

BOND MARKET OVERVIEW — INVESTMENT POLICY COMMITTEE

The Perfect Storm…

The gathering clouds from 2007's 4th quarter coalesced as we entered the new year, forcing the Fed into damage control mode with its expanding arsenal, including some new tools, and new uses for existing ones. Most dramatically were the F.O.M.C.'s cuts in the fed funds rates, both in their magnitude and timing.

> *"Officials have lowered the target rate for overnight loans between banks by 3 percentage points since September, with 2 percentage points since January, the deepest reduction since the Fed started using the federal funds rate as its main policy tool around 1990." Bloomberg 04/04/08*

With fed funds now at 2.25%, the markets are still anticipating another 25 to 50 basis point reduction at or before the April 29-30 meeting of the Federal Open Market Committee.

New tools in the Fed's battle to restore confidence and liquidity have included the 28-day Term Auction Facility (a longer term repurchase agreement than has been used in the past) that began being used on a biweekly basis in January, along with less stringent collateral requirements for securities delivered in exchange for the Fed credit. In addition, the Fed's discount window, heretofore only available to commercial banks, was opened to other financial institutions, such as the investment banks at the center of this credit crisis, in a further attempt to thaw the nation's credit markets.

The apex of the debt markets' flight to quality stampede was so intense during the weeks around the Bear conundrum that on March 19th the 3 month Treasury bill rate hit 0.57% - a 50 year low. Prices suggested less stress as the quarter ended, with 3 month yields at 1.3% and the 30 year bond closing at 4.3%.

Concerns that the Fed may be pushing on a string over the near term were centered around a variety of economic data indicting a slowing economy in need of some longer term resuscitation, and not necessarily just another blast of caffeine from lowered rates.

With 70% of the GDP's heavy lifting coming from the consumers' wallets (or debt), all eyes have been focused on how Joe and Jane Mainstreet are holding up in this environment. March nonfarm payrolls fell by a more than expected 80,000, pushing the unemployment rate up from 4.8% to 5.1%, and the January and February payroll numbers were further reduced by an additional loss of 76,000 jobs. This was the biggest drop in 5 years, and when combined with housing concerns, inflationary pressures and market volatility, it's easy to see why March consumer confidence was down 1.3 to 69.5 in March, the lowest since the recession of '90 – '91.

Additionally, housing prices, according to the Case-Shiller index, have dropped 10.7% since January 2007, and don't appear to have hit bottom yet. This reverse wealth effect shows up in consumer spending, which has been flat for February, along with the preceding three months, and is of concern given the impact this can have trickling through the economy going forward.

> *"…the jobs slump may heighten fears at the Fed of a negative "feedback loop" in which financial market strains lead to a weaker economy, which in turn leads to more financial turbulence."* *WSJ 04/04/08*
>
> *"Buried in the data is a picture of a squeezed consumer. Inflation is now running ahead of the growth in wages. As the chart below shows, average hourly earnings were up just 3.6%, but inflation was 4.5%. That means consumers must struggle to maintain their standard of living. No wonder retail stores shed 12,000 jobs last month. Light vehicle retail sales are down by 20% form last year. This all paints a picture of a very challenged consumer."* *John Mauldin 04/04/08*

Regardless as to whether or not we're already in a recession, there's no doubt that the domestic economy has slowed dramatically from the pace of the middle two quarters of last year. Similar to a bell curve, the 3.8% and 4.9% GDP spikes last year were ringed with quarters where growth was a significantly slower 0.6%. The more optimistic estimates for 2008 have Q1 coming in a 0.7% and Q2 at an even slower 0.4%...the less sanguine view has the U.S. already in recession.

The depth and breadth of this “contraction” will obviously impact interest rate direction and levels over both the short and intermediate term. Given the absolute level we find them at now, and in light of the inflationary pressures starting to manifest themselves, it’s difficult to envision much more upside moves in bond pricing, except perhaps from the distressed debt sector. It would appear plausible that after cutting rates further to stabilize and stimulate the economy in 2008, the Fed will be looking to raise rates in 2009, both to fight inflation and, ultimately, to support the dollar.

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

The “Safe Withdrawal Rate” During Retirement…

Recently, much has been discussed about what a safe withdrawal rate is during retirement. Historically, studies have shown something in the 4% to 6% range. When the Dot.com bubble burst, it burst a lot of those studies as well.

Today, most of us use what is called a Monte Carlo tool to help us gauge what could happen to a retirement portfolio. The Monte Carlo method involves running thousands of "what-if" situations on a portfolio using historical stock- and bond-market returns. The idea: Build a portfolio today that's likely to reach its goals in the future 80% or 90% of the time.

A key illustration of the Monte Carlo impact can be seen simply by varying withdrawal rates. It wasn't long ago that the conventional wisdom was that on a portfolio expected to earn 7% over time, an investor could safely pull out 7% a year and not risk running out of money.

But while that seems logical, it fails to take into account a simple fact: The markets don't move in a straight line. Experts began questioning the conventional wisdom on withdrawals during the mid-1990s, but during the bull market, when stocks were rising 20% a year, few heeded the message. That changed when stocks went into a three-year bear market.

IMCG employs a total return strategy to managing a retiree’s portfolio. In this way we focus on dividends, interest, capital gain distributions and capital appreciation. This total return strategy, coupled with the statistical-analysis, enables us to help our clients reach and maintain their retirement goals.

In retirement, you are better off with lower the volatility. Increased volatility reduces the average cost per share sold. You need to avoid selling shares when prices are low. This is what kills retirement portfolios. It reduces the Safe Withdrawal Rate.

With a dividend based strategy, you avoid selling any shares. Dividends provide a continuing income stream.

Investors who are approaching retirement are typically sold a wide array of fixed income investments like, bond funds, annuities and many other fixed income instruments. Those solutions do provide dependable income but with one significant drawback though – they don't account for the eroding value of inflation. Even a modest 3% annual inflation rate corresponds to a 24% decline in purchasing power after 9 years.

Dividends have historically accounted to 40% of the total stock returns over the past 80 years.

		Average Annual		Dividend Contribution
Decade	Price Return	Dividend Return	Total Return	To Total Returns
1900s	6.92%	4.56%	11.48%	40%
1910s	-0.43%	5.88%	5.45%	108%
1920s	10.96%	5.70%	16.66%	34%
1930s	-0.29%	5.05%	4.76%	106%
1940s	4.36%	5.83%	10.19%	57%
1950s	14.20%	5.28%	19.48%	27%
1960s	5.02%	3.26%	8.28%	39%
1970s	3.46%	4.14%	7.60%	55%
1980s	12.57%	4.55%	17.12%	27%
1990s	16.15%	2.64%	18.79%	14%
2000s	1.29%	1.66%	2.95%	56%

Stocks that pay dividends provide a nice inflation hedge. Dividends soften losses during bear markets, and they provide the only sources for investment gains in troublesome times. In addition, dividend income takes away the need to sell large chunks of your portfolio in a declining market.

Retirement income that could be solely derived from dividends and their growth would compensate the dividend investor for the erosion in the purchasing power of the dollar.

If our retirees hold a diversified portfolio of stocks which have the ability to grow their dividend payments over time, they would be well prepared for retirement. IMCG focuses on stocks with high yields and ability to grow dividends; stocks with average yields but with above average dividend growth and some foreign stocks and bonds to provide a weak dollar hedge.

Examples in early 2006 would include Bank of America 4.3%, Pfizer 4.0% and Coca-Cola 3.0%. All three companies have paid increasing dividends for decades and doubled their dividends in just the last 7 years.

While employing this strategy in retirement, we project that increasing dividends provide our clients with a cost of living raise as well as an inflation hedge. As we have seen, more and more of our dollars are going to expenditures such as gas, food and heat. The recent jump in gas prices aside, overall inflation hasn't been on the radar screen of many investors. But even slight changes in the inflation rate, over time, can have an amplified effect: At inflation of 3% a year, a retiree's expenses could double within 25 years, but at a rate of 5%, costs would triple.

Another important variable: health-care costs, which have been rising at more than double the pace of the overall inflation rate. This will be the topic of next quarter's newsletter.

As always, please don't hesitate to notify us of any changes to your current situation or expected cash flows, as it all relates to the planning we do.

INSIDE THE MARKETS — FRANCIS J. DAVIES III

"As house prices fall, a huge amount of financial folly is being exposed. You only learn who has been swimming naked when the tide goes out -- and what we are witnessing at some of our largest financial institutions is an ugly sight."

~ Warren Buffett, CEO of Berkshire Hathaway Inc., 2008 annual letter to investors

One of the causalities of the current financial upheaval will be the "financial supermarket". The "one-stop shopping; get your insurance, checking account, IRA, investment brokerage, business loans all under one roof" approach. Its death reminds us how important it is to focus on what one does well and leave attempting to be all things to all people to the professionals (also known as politicians).

The inherent risk in combining investment banking with commercial banking was clear in the wake of the Great Crash. The Glass-Steagall Act, passed in 1933, prevented a bank holding company from owning other financial firms. After it was repealed in 1999, allowing the creation of massive firms like Citigroup and UBS, the situation can best be described as "Katy bar the door". As Jean-Marie Eveillard, a legendary investor who runs the First Eagle Global Fund in New York put it, "Glass-Steagall protected bankers against themselves. Bankers are sheep. They don't mind going over the cliff if everyone else goes over the cliff."

Ironically, this move was meant to decrease risk – to the firms and to the markets. One business unit would feed the others and the diversified sources of revenues would decrease earnings volatility. It is now clear that the divisions were linked – when one suffered, they all did. Problems in consumer banking caused by sub prime mortgage issues created difficulty for institutional investors that bought securities backed by those loans. This pain also migrated to credit card operations.

As the economy boomed and housing prices soared, it looked like a wonderful strategy. Bank executives grew confident in their ability to manage multiple risks. The trading operations got cheap capital from the sedate wealth-management divisions and used it to leverage investments in risky trades. Intricate investment products were structured and sold – sometimes back to the same firm. Risk management controls – especially the use of highly complex derivatives – removed the danger. Trading desks took on holdings too convoluted for any risk management to be effective.

Without Glass-Steagall to rein in animal spirits, commercial lenders such as Citigroup (the largest U.S. bank by assets) could, through their investment banking arms:

- underwrite and trade instruments such as mortgage-backed securities and collateralized debt obligations and then

Post Office Box 4802 ♦ 97A Exchange Street ♦ Portland, Maine 04112
1771 Post Road East ♦ Westport, Connecticut 06880
207.774.6552 ♦ 800.605.6552 ♦ FAX 207.775.2969
www.imcgrp.com ♦ info@imcgrp.com

- establish so-called structured investment vehicles, or SIVs, that bought those securities.

The firm creates a product and then sells it to another part of the same company. That is a closed loop. And all the risk stays in house.

Within the past week, the former CEOs of two of the largest firms have questioned the bigger is better tactic. John Reed, the former CEO of Citicorp, has said that the $166 billion merger of Citicorp and Traveler's Insurance in 1998 was a mistake. Citigroup is being forced to raise $30 billion of capital to repair its balance sheet. It has fired 6,000 employees and slashed the dividend on its stock. Citi shares have lost more than half their value in the past year.

UBS has the world's largest wealth-management division. It also has an investment banking arm that has lost $37 billion in the sub prime crisis to date. Luqman Arnold, a former CEO of UBS, wants to break up his former employer. He has said, "We are not convinced that the 'one bank' integrated business model … will survive the damage inflicted by the proprietary trading losses and write-downs." He is pressing for a change in the bank's management and a sale of the asset management business to separate the investment and private banking arms. The chairman and the architect of the firm, Marcel Ospel, is stepping down. UBS will attempt to raise $15 billion in new capital through an emergency rights issue.

Size and complexity, once seen as the savior of investment firms, is now the source of most of their trouble. The complications obscured the overlaps and the risk compounded. Now these firms are being forced, by circumstance and by regulators, to simplify. The resolution will probably look like the outcome of the 8 month battle over Dutch banking group ABN AMRO. The firm was taken over and is being broken up. There is more value in the separate parts than as a conglomerate.

Regulators are going to raise capital requirements, effectively deleveraging the bets and making those trades less risky and also less profitable. There is also a deeper problem in these days of stolen identities and financial turmoil. Would any consumer be comfortable depending on one institution for all their financial accounts? Not very likely. Which is why there are so many boutique firms. Some things are better handled by a specialist.

IMCG NEWS

FREDRIC W. WILLIAMS: Was recently appointed to the Board of Directors for VNA Home Health & Hospice, a partnership with Mercy Hospital based in South Portland, Maine. Fred will serve on the Finance Committee; additional information about the organization can be found at www.vnahomehealth.org.

EVENTS OF INTEREST:

- **Ballyhoo –** The first community celebration of the merger of Ingraham and Youth Alternatives will be held Thursday, April 17th at the Holiday Inn By The Bay. Additional information can be found at www.youthalternatives.org .

- **Bids For Kids –** Big Brothers Big Sisters of Southern Maine's annual auction will have "Spring Fever" as its theme, Friday May 16th at Holiday Inn By The Bay. Additional information can be found at www.somebigs.org .
- **15th Annual Child's Play Golf Benefit –** The Dream Factory of Maine's annual event to raise funds for its mission of granting dreams to the critically and chronically ill children of Maine. Friday June 6th at Sable Oaks starting at noon – additional information can be found at www.dreamfactoryofmaine.org