INVESTMENT MANAGEMENT & CONSULTING GROUP

VIEWPOINTS

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MARKET COMMENTARY FREDRIC W. WILLIAMS

Forever blowing bubbles…

Unlike the gentle role that champagne bubbles played in the music of The Lawrence Welk Show, asset bubbles have a way of popping suddenly and painfully for the trend followers that participate in the price run ups. Think tulips and tech stocks, as well as the more recent bubbles in residential real estate and private equity buy outs. The mantra on the way up involves something like "this is a new paradigm" or "this time it's different". On the way down the crowd realizes it is not different after all; that asset values do not move skyward forever and that prices always have to be tied to some sort of base fundamentals.

Over the last several years there has been a considerable run in commodity prices. Some have attributed this to rising demand from growing economies in the developing world, primarily the BRIC (Brazil, Russia, India and China) countries. This conviction has led many observers to believe that historically cyclical commodity prices are now permanently on the "up" escalator, as insatiable demand meets limited supply. One needs only to look at the ongoing surge in oil prices for an example. Speaking of bubbles, the rally in crude is now bigger than the NASDAQ composite's run during the Internet stock bubble.

Other analysts point to the new breed of commodity index funds as having an outsized impact on the direction of prices. Commodities futures markets were originally devised as a tool for the producers of a physical commodity – corn, wheat, oil, etc. - to hedge the eventual sale of their assets by selling an agreement to deliver the product at a set price on a set date in the future. Trading commodity futures quickly became an avenue for pure financial speculation.

Historically, speculators, like the producers, would be "long" and/or "short" the markets based on their perception of price levels and market direction. They provided additional liquidity to the markets, benefiting both commercials/hedgers *and* speculators/investors. This balance shifted as commodities began to be viewed as an "asset class" — no different than stocks or bonds. Big institutions needed to increase their exposure to this asset class. They bought long-only, buy-and-hold commodity index funds and overwhelmed the market equilibrium. Since 2004, assets in index funds that track a basket of commodities have jumped from $30 billion to $180 billion, according to S&P.

"Commodities index funds, which arrived on the scene in the late 1990s, have come into their own in the past several years…Index funds offer investors an easy, inexpensive way to gain exposure to a segment of the commodities markets or a broad-based basket of commodities. Result: The funds have drawn many private investors who have never ventured into futures, along with pension funds and other institutional players looking to diversify. But for all the virtues that the funds hold as a way of spreading bets across commodity markets, they take only long, or bullish, positions, avoiding short-selling. In other words, they trade on the naïve and potentially fatal assumption that commodities have the same tendency as stocks to rise over the long run.

That this large, bullishly oriented group of funds is flourishing is partly a result of a regulatory anomaly. <u>In recognition of the fact that the commodity markets are too small to absorb an excess of speculative dollars, the Commodity Futures Trading Commission, in conjunction with exchanges, imposes position limits on speculators. But the agency has effectively exempted the index funds from position limits.</u>" Barron's 3/31/08

The difference between what the commercials are thinking and what the speculators are doing has resulted in both camps positioning themselves, for the most part, on opposite sides of the same trades. Since both cannot be correct, one has to question why betting against the commercials, who should have an intimate knowledge of the commodity the hold or produce, would make much sense over the long term.

"Here's the problem: The speculators' bullishness may be way overdone, in the process lifting prices far above fair value. If the speculators were to follow the commercial players -- the farmers, the food processors, the energy producers and others who trade daily in the physical commodities -- they'd be heading for the exits. For right now, the commercial players are betting on price declines more heavily than ever before…For example, in the 17 commodities that make up the Continuous Commodity Index, net short positions by the commercials have been running more than 30% higher than their previous net-short record, in March 2004. These days, the data suggest, the smart money clearly believes that the market's exuberance has turned irrational. Indeed, the great commodities bubble started springing its first leaks two weeks ago: Oil, gold and other major commodities posted their steepest weekly drop in half a century. Though prices have since firmed, they could eventually drop 30% as speculators retreat. The only real question is when." Barron's 3/31/08

With oil futures up 9% in June, 25% since the first of May and 47% since the first of the year, pure fundamental supply and demand pressures from a global economy that is obviously slowing economy doesn't appear to make sense. One has to wonder if all the elephants clamoring to get on the commodities dance floor aren't distorting prices with their preponderance of long-only one-way trades.

"There is growing evidence of an oil bubble, though evidence of asset bubbles isn't conclusive until they burst. The trajectory of oil prices in the past eight years looks eerily similar to the NASDAQ's eight-year run to a peak of more than 5,000 in March 2000. More than eight years later, the NASDAQ is at half that level.

Oil market experts acknowledge that commodity-indexing strategies employed by endowments, pension funds and other institutional investors have helped push up prices in the past year. Such investments are thought to have totaled $260 billion as of March, up from $13 billion at the end of 2003, according to Michael Masters, the head of Masters Capital Management, an Atlanta investment firm. Some $55 billion may have flowed into commodity investments during the first quarter alone. The energy complex is the largest commodity market, and gets a disproportionate share of fund flows. Masters estimates index participants may control over 1 billion barrels of crude.

Managers of leading university endowments, including those at Harvard, Yale and Princeton, in recent years have generated outsized returns from investments in hard assets, prompting other investors, such as the giant California Public Employees Retirement System, with over $200 billion in assets, to attempt the same. Calpers is upping its commodity exposure to $7 billion from under $500 million." Barron's 6/23/08

Although we have no doubt that over the long term a recovering, and then growing, global economy will demand more of the numerous resources represented in the various commodities markets, thereby causing supply/demand dynamics to contribute to inflationary pressures in the future. The question we ask, much as we did with the dot.coms in the late 90s, is whether the markets haven't gotten way ahead of currently justifiable reality due to the tunnel vision of myopic traders. As David O'Reilly, chief executive of Chevron, recently stated we asked about his understanding of current oil prices, "We can see how you can get to $100. At $140, I just don't know how to explain it. We're surprised."

Increasing domestic interest rates, which we see entering the investment arena sometime in 2009, will cause the dollar to strengthen and could contribute to the release of air from the commodities bubble – particularly oil. Since oil is priced in dollars, its price rises as the dollar falls. Investors have seen oil as a hedge against the dollar's falling value, plowing funds into the commodity and pushing prices up further. Rising domestic interest rates could reverse both of those trends in the near future. In addition, a reduction in petroleum prices could go a long way in helping the consumer balance sheet get shored up, leading the way for a future recovery in the economy – something that will be preceded by a rebound in the global equity markets.

Three for Three…

The 2nd quarter of 2008 was the third consecutive quarter that the major domestic indices declined – something that hasn't happened since the '70s – an outcome very different than the one envisioned by investors in early April.

> *"It is a big change from three months ago. The second quarter began with high hopes that the worst of the credit crunch was over, earnings growth would pick up as the year went on and stocks would rise.Those hopes were shattered as the effects of the credit crisis lingered and it looked like consumers might stop spending.*
>
> *Investors acknowledged the grim reality beginning in mid-May. That is when the Dow Jones Industrial Average began its march downward, ending the quarter (including Monday's slim 3.50-point gain) with an overall loss of 912.88 points, or 7.4%, at 11350.01 -- and perilously close to the 20% decline from a recent high that is considered the start of a bear market." WSJ 07/01/08*

Despite the prevalence of bearish headlines, both the domestic and global equity markets produced a broad array of returns, depending on both their compositions and valuations. The Dow Industrials, heavily populated with financials still reeling from the sub-prime induced credit crisis, closed the first half of 2008 down 14.4%, while the Dow Utilities, benefiting from their defensive perception and modest energy exposure, attracted bids and rallied 8.7% to hit the mid year mark off only 2.2%.

The S&P 500, with about a third of its capitalization related to finance, dropped an additional 3.2% in the 2nd quarter and was off 12.8% year to date,. The NASDAQ, absent significant exposure to the financials added 0.5% in the quarter to cross the mid year mark down 13.5%.

Overseas performance was equally disparate:

> *"From Shanghai, where shares were down 21% for the second quarter, to Paris, down 6%, to the U.S., stocks ended up taking a beating. Among the few markets left unscathed was Canada, the commodity-rich neighbor of the U.S., where stock prices rose 8.4%. Japan also mounted a second-quarter comeback after a dismal first quarter (up 7.6% after an 18% 1st quarter drop)… Elsewhere in Asia, Hong Kong, Mumbai and Singapore have dropped 21%, 34% and 15%, respectively, so far this year, while smaller markets like the Philippines, Vietnam and New Zealand have fallen 32%, 57% and 21%, respectively. Many of them added to a bad first quarter in the last three months." WSJ 7/01/08*

Although still weak in the 2nd quarter, the developed markets lessened the rate of decline after 2008's initial quarter. London's FTSE 100 eased 1.3% to close down 12.9% for the year, Frankfurt's DAX was down 1.8% (off 20.4% through mid year), while the Paris CAC 40 dropped 5.8% for a mid year decline of 21%.

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As we have written about previously, investors need to recognize that outsized asset gains on the upside can often times be followed by excessive volatility on the down side. Think back about tech stocks in the late 90's, residential real estate, private equity deals and now, perhaps, commodities.

During times of market turmoil it is instructive to retain a more linear, rather than emotional, view of cycles, valuations and one's individual timelines. During the first quarter, the media was fixated on the question of a recession, something that will not be conclusively known until next year. In the 2nd quarter, the focus changed to the existence of a bear market – less than 12 months after the media was heralding all time highs driven by the private equity (and overly leveraged) boom of 2006 and 2007. Much as we cautioned last year during the market's ascent about nothing going up forever, the same needs to be said for market declines.

> *"The good news is that once the decline reaches that arbitrary 20% mark, based on history, the market has suffered most of its losses. The bad news is that the decline typically drags on for some time, and time may be the worst enemy. Investors may initially try to grab erstwhile highfliers that have crashed and burned but rarely regain their former status. And as the decline wears down investors' psyches, they tend to bail out at the market's nadir, when things look bleakest -- and when the greatest opportunities present themselves." Barron's 7/07/08*

Although it appears trite, one of the simple dictums of successful long term investing is buying low and selling high. This requires a sense of contrarian thinking given that it often times is not what the crowd is fixated on, and the ability to look at the more relevant long term horizon, rather than just focusing one's investing toes.

Once the domestic indices work off the excesses of the private equity bubble of 2006-2007, there will be compelling opportunities over the next 6 to 12 months and prudent, long-term investors will be able to take advantage of attractive valuations for their long-term benefit.

BOND MARKET OVERVIEW — INVESTMENT POLICY COMMITTEE

One and Done… (for now)

Following their frenetic rate activity in the first quarter, the F.O.M.C. cut rates only once during second quarter, at the end of April, and then stood pat at the June meeting. The Fed expanded its arsenal of tools in the wake of the Bear Stearns disaster and it made use of them – providing liquidity to both commercial and investment banks through newly minted term auction facilities. This seemed to calm the credit markets during April and May.

The relief rally succumbed to renewed fears in June as the prospect of additional losses at investment banks combined with continuing concerns about the viability of the bond insurers and the condition of the housing market. The end of quarter flight-to-quality resulted in lower rates on Treasuries and higher rates for lower rated paper. The 2 year Treasury closed the quarter at 2.63%, having peaked at 3% in early June.

The dominant theme from the first quarter was the ongoing credit crisis and the concern for additional casualties in the financial services sector. A developing worry was inflation, both at home and abroad, as food and oil prices surged. The prospect for higher rates from the Fed weighed heavily on equity market valuations, while the spread between the European Central Bank's (ECB) main rate of 4.0% and the Fed funds rate of 2.0% continued to put downward pressure on the dollar versus the euro.

Given that each institution has slightly different mandates (the ECB to fight inflation; the Fed to fight inflation *and* foster economic growth) what they do over the next year will continue to roil the markets. Rising European rates would hurt the dollar and push commodity (oil) prices higher, while higher rates from the Fed would hamper any nascent domestic economic recovery. This dilemma is beginning to box the policy makers in from a monetary standpoint, as well as impacting the economy as a whole:

> *"Rising fuel prices helped push vehicle sales to a 15-year low in June, but they're not just hitting demand for the trucks and SUVs that have been the staples of U.S. auto makers. Consumers are starting to worry that their cost of living could get out of hand. And the latest surveys of business leaders by the Institute for Supply Management show most industries looking to raise prices. Higher inflation expectations can be self-fulfilling, and the Fed has made clear that a 2% target interest rate is too low to contain such pressures for long…Though weak U.S. growth probably will stave off any rate hikes for several months, the course is set for bigger borrowing fees." Barron's 7/7/08*

With June representing the sixth straight month of declining payrolls (down 62,000 – with April and May being revised lower by an additional 52,000 as well), a jump in the May unemployment to 5.5% and the continuing decline in housing, it is easy to see why consumer confidence is residing in the commode, despite the one-off impact of the government's economic stimulus checks.

With the current bias towards globally rising rates, we will continue our focus in the short to intermediate portions of the yield curve, as well as on the floating rate and inflation protected issues that can provide a hedge against increasing interest rates.

WEALTH MANAGEMENT UPDATE — TRACY W. ROGERS

Applying for College Financial Aid

This is the time of year when people traditionally look for help paying for the coming fall semester. Helping our clients navigate the intricate process of applying for financial aid, we have learned that it is not a level playing field. We wanted to share some of the facts and dispel a few of the misunderstanding we have encountered. Parents should know that there are two formulas for determining financial aid; that some colleges will actually negotiate the amount of aid and that, on occasion, a college may want a particular student enough to pay for their tuition.

The first need analysis formula is "**Federal Methodology"** (FM). This is used to determine a student's eligibility for federal aid, including Stafford Loans. Federal aid eligibility is determined from the data the student provides on the Free Application for Federal Student Aid (FAFSA). Using FAFSA data, FM calculates the student's "expected family contribution" (EFC) which is displayed on the Federal Student Aid Report (SAR) received by the student.

Since the EFC calculation ignores some forms of income and eliminates some assets from consideration, many universities use a more traditional formula called the **"Institutional Methodology"** (IM) to determine a family's need for aid. IM more accurately and equitably determines the parents' ability to pay for a medical education from family income and assets. A student may have whatever federal aid is available based upon eligibility under Federal Methodology.

Some of the items that the IM looks at that are different than the Federal Methodology are below;

- Wages
- Interest & dividend income
- Nontaxable income (detailed)
- Business & rental income and losses
- Taxes paid, tax credits, itemized deductions
- Cash, savings
- Investment equity
- Business, real estate, farm value and debt
- Non custodial parent information
- Parent assets held in siblings' names
- Student trusts
- Medical expenses
- Family members enrolled in college and siblings in pre college tuition based schools

As you can see, the IM is much more detailed. Parental business expenses and losses can be added back to income. Home and business value and debt are looked at as well. Assets held in trusts that were designed to shelter them from the federal method are also counted. Once your child decides to go to a school that uses IM and you have made yourself look poor on paper to no benefit, what can you do?

Negotiate?

Negotiation refers to the idea that you can haggle with the financial aid office to get a better financial aid package. Very few schools negotiate. Those that do still follow a set policy that limits alternatives. Bluff and bluster will not get a better deal. You cannot play one school off another to get them in a bidding war for a student. Students are effectively commodities with little bargaining power.

On the other hand, colleges do have the authority to make adjustments to a student's financial aid package in cases involving unusual circumstances through a process known as *Professional Judgment*. In fact, most cases of negotiation are simply misidentified cases of professional judgment.

For example, a family might get two different financial aid offers from similar schools, and try to negotiate with one school to match the other school's offer. The first school asks the family whether there were any unusual circumstances that they told to the second school but not the first. Sometimes it is merely a matter of the second school getting more recent information.

In other cases, the school's financial aid application might include questions designed to elicit information about unusual circumstances. When the first school finds out about the unusual circumstances, they are often able to make adjustments to compensate for the unusual circumstances. This often results in an improved financial aid offer.

This "professional judgment" is where the schools go back to their coffers and see what they can do. While there are differences of opinions on this matter, it would be prudent to find out from school to school what their respective polices are. Below is an excerpt from the UCLA committee for financial aid:

> *"Since the following factors would cause a violation of the principles of need analysis which apply to all families, the Committee will* ***not*** *give reconsideration due to: Differences between the institutional need analysis and eligibility for federal aid under the Federal Methodology;* ***aid offers from other colleges and universities (whether based on the other institution's definition of need for merit)****; the spending pattern of the family; or the consumer indebtedness of the family."*

As you can see, while UCLA will reevaluate aid based on family factors, disability, death or other factors, they do not negotiate the aid package. In contrast, other schools are using financial aid, in the guise of merit scholarships, to buy perceived talent. Financial aid is normally thought of as help for the needy student who would be shut out of college because his family lacked the resources to pay the tab, but the scenario has changed. In order to compete in the U.S. News and World Reports' College ranking game, schools will use this money to entice students that the school needs to improve its ranking.

A recent article in the New York Times discussed this very subject.

> *"In the competitive scramble for prestige and rankings, numerous colleges already try to lure some top students away from the Ivy League by showering them with merit aid" even if they are well off and can afford full tuition. The practice is controversial, with some college administrators scorning it as a way of "buying" a better incoming class, sometimes at the expense of lower-income students. Some administrators say there will now be pressure to provide more merit aid to relatively wealthy high achievers, reducing the amount available to poorer students."*

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Thus some of the aid that was destined to help the neediest of students may just be going to the ones that need it least. Until you get involved in the process you really do not know what the education will cost. There may or may not be wiggle room and may be able to find a better deal by going down the street to another college. Or maybe, just maybe, you might hit the lottery and have the child that every college wants.

INSIDE THE MARKETS FRANCIS J. DAVIES III

Secular Change on Wall Street

"It sounds like even the firms that aren't in trouble are in trouble."
~ Tom Wolfe

The author of "Bonfire of the Vanities" (amongst many notable works) was surveying the wreckage in the investment industry when he made this trenchant observation about a month ago. Mr. Wolfe is a long time observer of the peculiarities of Wall Street and has written knowledgably about the ups and downs of the financial industry. "Bonfire" was published in 1987 shortly before the crash on October 19. Back then, the huge salaried "Masters of the Universe" in the business were investment bankers and bond traders.

Scandal, regulation and natural evolution has diminished those specialties in favor of the hedge funds and private equity firms that drive profits in the sector today. Now those entities are facing scandal and regulation of their own. Two years' worth of brokerage firms' profits have been written off in the wake of the sub-prime bust and the collateral damage done to the credit markets. The financial industry is not dead – but it is severely wounded.

Some of the recent headlines: financial firms have laid off 83,000 people; Bear Stearns went bust and was acquired by JP Morgan under dubious circumstances; the vultures are circling Lehman Brothers; bond insurers have been downgraded and Citicorp is in a death spiral. Once again, Wall Street needs to find a new way to create profits. The inflation and collapse of the bubble that created these losses damaged more than just the big firms involved. The real estate sector was allowed to inflate to dangerous levels with the increasing securitization of sub-prime debt. The correction in housing prices and supply will take years to work through the system.

Viewed from the outside (not as an employee or investor) these are healthy developments. The engine behind recent outsized profits was the securitization of all types of inappropriate debt. This was the sham of "sophisticated financial instruments" - the repackaging of lower grade debt into large pools that then were highly rated. Financial alchemy. Returns were boosted by excessive use of leverage. Leverage is fine when asset prices move according to plan. When markets turn - losses pile up quickly. The collapse of two Bear Stearns hedge funds that invested in debt securitized by pools of sub-prime mortgages was the trigger that caused the avalanche that buried that firm.

There is a fairly recent precedent for Wall Street's current state of affairs. In 1973, oil prices were surging, the economy was comatose and inflation fears were traumatizing the credit markets. In response, the financial industry shrank employment by 15%. When conditions did not improve the next year, an additional 12% of the work force was laid off. The country emerged from recession in 1975 and Wall Street began its epic bull run in 1982.

The lessons learned from these cycles of boom and bust are practiced everyday at IMCG if not at the big brokerages. We avoid the latest fad if it does not make economic sense; diversify investments and holdings (Merrill Lynch was saved from the Bear Stearns' ash heap by their earnings from their retail brokerage business); treat clients with the respect and honesty they deserve - client service takes precedence over proprietary trading or selling product.

Brokerage firms lost clients after burning them in the high tech bubble. They will lose more now. They continue to try to kill the goose that lays the golden eggs. We will continue to offer unbiased advice without compromise. And we will still be here after the next Wall Street stumble.

IMCG NEWS

EVENTS OF INTEREST:

- **Greg Francoeur Memorial Golf Tournament –** The 5th annual event to benefit the scholarship fund managed by the Maine Community Foundation:

  > *"Greg Francoeur was an avid skier who took great joy in sharing his love of the sport. He was particularly interested in helping younger skiers perfect their technique and devoted many hours to the students enrolled in the weekend program at Carrabassett Valley Academy. Greg's family and friends established this Fund to celebrate Greg's passion for excellence and to encourage others to strive for their personal best. Scholarship support will be provided to students enrolled at Carrabassett Valley Academy who would not be able to take advantage of educational and training opportunities without financial assistance. While skiers of all styles are invited to apply, Greg's forte was freestyle and the Advisory Committee is particularly interested in supporting skiers who share the same interest."*

  Contact Gary Francoeur at gfranco1@maine.rr.com for more information about the event to be held Friday morning July 11th at the Val Halla Golf Course in Cumberland, Maine.