



VIEWPOINTS

3RD QUARTER 2008

ADVISORY NEWSLETTER

MARKET COMMENTARY

FREDRIC W. WILLIAMS

Volatility...and Eventual Opportunity

The events of the last year have justifiably given pause to many investors as the landscape of the investment world has changed, much of Wall Street has vanished, and the uncertainties of a successful conclusion to the credit crisis have been debated in the media, while being wielded as political sabers prior to the upcoming election. During times like these we feel it's important to maintain perspective so appropriate linear decisions can be made during these emotionally volatile times. Not to diminish the significance of recent developments, but it's important that long term investors keep their wits about them lest they be swept up in the wave of lemmings hell bent for edge of the cliff.

There is no doubt that we've witnessed seminal events in the history of the financial services industry this year, and no doubt the repairs associated with these market "mishaps" will require both time and significant effort for any sense of normalcy to return. That being said, it's instructive to understand where we are within the context of where we've been so we might have a better sense of where we could be in twelve to thirty six months. Volatility should not lead to investment paralysis, but rather the prudent search for opportunity. We are reminded to buy low and sell high for a reason – often times the contexts for these two extremes creates an uncomfortable environment for those contrarians who adhere to the mantra of acquiring cheap and disposing dear.

As our readers will remember, we first wrote about the residential real estate bubble, and our concern that it had become over valued, in this space during the 2nd and 3rd quarters of 2006:

Déjà Vu All Over Again?...

"Our concern is that now, as the music stops and air comes out of the bubble, the decline in housing values will impact consumer's ability to "spend" our GDP forward."

-IMCG Investment Policy Committee; June 2006

"We are not the type to pile on, or kick a heretofore significantly positive contributor to our economy when it is down. However, having witnessed the tech bubble of the late nineties, we cannot help but compare it to our most recent asset bubble – the residential real estate market, complete with the return of the nineties mantra "this time it's different." Viewpoints Q3 '06

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We followed that in Q1 2007 with observations about the mortgage market excesses that contributed to the problem and hypothesized about its eventual impact:

Sublime Sub-prime...

With all deference to the sensitive psyches of the Neanderthals in Geico's commercials, you would have had to inhabit a cave over the last several months to not have heard about "sub-prime" mortgages and their potential impact on the housing market and the economy at large. The media banter has focused on both the lending practices that have brought this problem on, as well as the potential spillover effect that foreclosures may have on housing prices and consumer spending.

(Please see Terry Davies' comprehensive overview of the debt market history and resulting financial issues in the "Inside The Markets" section below)

Since then, it goes without saying that capital markets worldwide have had a rough go of it, with the stresses taking down commercial banks, thrifts, investment banks and insurance companies – to say nothing of the sharp and widespread decline in the value of residential housing. Understanding that the foundation for economic stability from this downturn, as well as the basis for an eventual recovery in the financial system, will require a floor to be placed under housing values, we need to look at past market declines within the context of our current circumstances.

According to Standard & Poors (The Outlook – 7/16/08), there have been 9 bear markets since 1956 where the S&P 500 declined by 20% or more. The average duration of the downturn was 14 months (we are entering month 12) and the average time from peak to the point of 20% decline was 9 months – something we matched in July of 2008. Although it's not prudent to project linear conclusions from averages, it's still instructive to note that the average price gain 12 months out from the date of the 20% threshold being met, is 16.5%. Even the market crash of 1987, which had a one day decline of 22%, saw the indices hitting new highs just over 2 years later.

We saw stagflation and the oil embargo in the 1970's, Treasury bill rates at 18% and a S&L bailout in the '80s, the Asian currency crisis and the collapse of Long Term Capital Management in the '90s, along with the bursting of the tech bubble at the start of the new millennium. Although each was unique in nature and presented numerous short term problems to overcome, our economy and markets recovered quite nicely for patient long term investors. To paraphrase Elton John & Bernie Taupin from the 1983 album "Too Low for Zero", we're still standing.

With regard to our current crisis, we see the ongoing deleveraging of the global financial system continuing to exert downward pressure on capital markets as hedge funds, private equity groups and banks have to unload assets to meet their capital and cash needs. We are not advocates of government intervention in the free markets as it reinforces inappropriate behavior. In its purest sense, capitalism without failure is like religion without hell – not the most effective way to have various risks and rewards sort themselves out. That being said,

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we do believe that the magnitude of our present challenges will require the balance sheet of last resort (the U.S. Treasury) to provide the liquidity and long term time horizon necessary to restore the system to its normal operating structure.

Fear and greed drive both Wall Street and Main Street – for better or for worse. We do not believe that Wall Street’s greed should go unrepented, and the disappearance of the investment banks into commercial banks will be the first step toward less speculative leverage and more regulatory oversight. Market history has shown us that bulls and bears always survive, and that it’s the pigs that get slaughtered. Given the number of pink slips floating down the canyons of lower Manhattan, it appears that plenty of chorizo and bacon is being, and will be, served on Wall Street.

EQUITY MARKET OVERVIEW

INVESTMENT POLICY COMMITTEE

Dramamine All Around...

To think that the domestic indices had an “interesting” September would be a vast understatement as the Dow had more than 100 point swings in 15 of the 21 trading days that closed out the 3rd quarter of 2008. The pain from the continuing credit crisis pressured the globe’s capital markets for another quarter, culminating in a flurry of activity and deals as economics was trumped by politics as the month closed.

“Given the events of the past month, it is a wonder stocks weren't down more. The Dow Jones Industrial Average lost 4.4% in the latest quarter and is down 23% from its peak last October. The Standard & Poor's 500-stock index is off 9% from the end of June and down 26% from its high. The Nasdaq Composite Index, meanwhile, dropped 9.2% in the third quarter and is 27% below its multiyear high set last Halloween.

That certainly qualifies as a bad quarter, but on a percentage basis it doesn't even break into the top-ten worst quarters for the S&P 500 and is only the 25th-worst quarter of all time for the Dow.

There were jaw-dropping, historic events in the quarter's final month. Fannie Mae and Freddie Mac were taken over by the government, Lehman Brothers Holdings Inc. filed for bankruptcy protection, Merrill Lynch & Co. was acquired, American International Group Inc. gave the government control of the company in return for an \$85 billion loan, Washington Mutual Inc. was seized by federal regulators and the bulk of its operations sold off, and regulators orchestrated the sale of Wachovia Corp.

Meanwhile, Goldman Sachs Group Inc. and Morgan Stanley survived only as a result of large infusions of cash and a decision to give up the traditional Wall Street investment-bank model, turning themselves into commercial banks so they can borrow from the Federal Reserve.”

WSJ 10/01/08

Overseas markets fared no better as the housing/mortgage contagion continued to spread, morphing into a crisis of confidence that frosted the debt markets (see below) and burned the equity markets as investors chose to sell first and ask questions later. London’s FTSE 100

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dropped 13% to close down 24.1% for the year, Frankfurt's DAX was down 7.3% (off 27.7% after three quarters), the Paris CAC 40 slipped 7.2% (a decline of 28.2% YTD), while Tokyo's Nikkei was off 17% and is down 26.4% through September.

Even parts of the resource rich developing world which had benefited from the commodities bubble saw the air start to dissipate:

“As commodity prices fell back from highs, the retreat slammed stocks that had benefited from their rise. Resource-heavy markets such as Brazil and Russia were two of the worst affected, down 24% and 47%, respectively, in the quarter.

“Russia experienced a stock-market crisis in September, as the conflict with Georgia, falling oil prices and widespread aversion to risk made local and foreign investors head for the exits. Trading on Russia's two main stock markets was halted repeatedly.

“The upheaval in Russia's markets fit into a world-wide pattern of investors fleeing from anything perceived to be risky and unwinding trades that depended on borrowed cash. American investors, who have sent money overseas in search of profits in recent years, beat a retreat.”

WSJ 10/01/08

In light of this pricing volatility, we noted the following last quarter in this space:

“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.”

Viewpoints 07/01/08

Although typically the equity arenas attract the majority of investor interest, this year's third quarter was marked by a focus on the stress in the debt markets, as the tail was most definitely wagging the dog. As discussed below, absent a fully functioning credit market, the short term financing that most businesses operate on vaporized, leaving successful companies scrambling to meet funding requirements. This caused equity analysis to be more a function of corporate liquidity than the viability and profitability of a product or service being offered in the marketplace. Washington Mutual and Wachovia are prime examples of a run on their deposits, which eroded their capital base, compromising their ability to survive and forcing them to be taken over by the FDIC, or sold to better capitalized competitors.

A reasonably well known and successful long term investor, with the last name of Buffett, put his money where his mouth was this quarter as he took advantage of market conditions to put some of Berkshire's \$44.3 billion cash position to work. In September alone he committed \$5 billion to Goldman Sachs, \$3 billion in General Electric and \$4.7 billion in Constellation Energy...all a significantly lower levels that seen just 9 months ago.

In a recent PBS interview, Mr. Buffett opined about the value of cash in a portfolio by pointing out, “There are times when cash buys more than other times, and this is one of those times where it buys more.” Ample reason, it would seem, to keep some powder dry in today's investment world.

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In the same interview, Uncle (potentially to the U.S. financial system) Warren provided some sage advice for these emotional times, "You want to be greedy when others are fearful and you want to be fearful when others are greedy." As we work our way through these most recent challenges in our economy we feel this type of contrarian perspective will serve long term investors quite well...much like it has in Omaha.

BOND MARKET OVERVIEW

INVESTMENT POLICY COMMITTEE

Not Yet In Defrost Mode...

As noted above, the real action (or lack there of) in the capital markets this last quarter centered in the bond market and its inability to keep the wheels of liquidity turning, seizing up the short term credit markets and sapping the business world of the capital needed to keep day to day operations functioning smoothly. Despite the rhetoric coming from Washington, this was not just a Wall Street issue but was trickling down in torrents to Main Street through payroll and cash flow challenges effecting small businesses – the driving force behind employment in this country. Absent any decisive and comprehensive decisions on the political front, the credit markets and the commercial paper markets froze denying the access to capital that the companies which are the basis for our economy need.

“The amount invested in the US commercial paper market fell by \$95bn during the past week, increasing concerns about the availability of money for banks and companies from this vital source of short-term funding.

Data released by the US Federal Reserve showed the amount invested had its biggest weekly drop since the central bank began tracking the sector in 2001.

In the past three weeks, the Fed data have shown that more than \$200bn has been taken out of CP, a type of short-term debt that was widely bought by money market funds.” (Financial Times 10/02/08)

This same dynamic was evidenced within the U.S. banking system as institutions sought to meet their capital and reserve need requirements:

“U.S. banks' borrowed a record \$367.8 billion per day from the Federal Reserve in the latest week, as financial institutions relied heavily on the lender of last resort amid the most severe credit crisis since the Great Depression.

With interbank lending markets frozen and commercial paper markets near paralyzed, there is virtually nowhere else where banks can get short term funding except the central bank.

Banks' discount window borrowings averaged \$367.80 billion per day in the week ended October 1, nearly double the previous record daily average of \$187.75 billion last week, Federal Reserve data released on Thursday showed.”

(Reuters 10/02/08)

Predictably, the stresses in our financial system are not isolated to what politicians are expediently labeling “Wall Street”, as they focus on positioning themselves for the upcoming November elections. With two thirds of our nation’s GDP a function of consumer spending,

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and small businesses being our country's largest employer, issues within our financial system become more than mere indigestion on Main Street:

"The U.S. economic outlook darkened further last month as companies shed workers at the fastest pace in more than five years. Nonfarm payrolls tumbled 159,000 in September, the Labor Department said Friday, the sharpest decline since March 2003. The unemployment rate, which is calculated using a separate survey of households, was unchanged at 6.1%."
WSJ 10/03/08

In previous quarters the bond market would get its lead from the F.O.M.C. meetings and rate decisions. During the 3rd quarter the Fed kept the funds target rate steady at 2% and focused instead on various mechanisms to provide liquidity to the financial system. Continued lending to commercial and investment banks was augmented with efforts to back money market funds and expand FDIC coverage for bank deposits in the hopes that these two sources of potential short term capital would not end up under the mattress.

And although the yield curve remained fairly stable throughout the quarter, the pressures on the credit markets were expressed through investor fear as they drove spreads to historic levels. The gap between double-A rated corporates and Treasuries jumped from 2.35% at the start of the quarter to 4.17% at the end, while the single-A spread expanded from 2.86% to 5.21% over the course of the summer's three months.

The bond market's credit crisis is being exacerbated by a fear induced liquidity vacuum which will continue to drag the economy down the longer it persists. We are advocates of free markets and find ourselves uncomfortable with the concept of government support. We are, however, also pragmatic to the extent that should Adam Smith's invisible hand demonstrates spastic tendencies, we recognize the need for intervention to preserve the greater good of the overall economy.

Although our near term perspective on the economy is akin to monitoring a patient in the intensive care unit to evaluate the efficacy of the therapy, we believe these challenges will be worked through, thereby leaving our intermediate to longer term view of the bond market unchanged. 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 which we see as the inevitable result of any form of systemic stabilization program.

WEALTH MANAGEMENT UPDATE

TRACY W. ROGERS

Pending Retirement Plan Changes Effecting 401(k)s – Section 408(b)(2)

In addition to working with individuals and families, IMCG also advises qualified retirement programs such as 401(k)s, 403(b)s, defined benefit and profit sharing plans. We assume the same role we take in working with our individual clients: that of a fiduciary, not a salesperson. (The legal definition of a fiduciary is one who works for the sole benefit and interests of another, with loyalty to those interests.) As a fiduciary, we work on a fee-only

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basis and fully disclose all expenses and costs. The first step is also the same: in both cases, before making any recommendations we conduct a thorough analysis of client needs based on their unique situation. Our individual clients fill out a detailed questionnaire. For retirement plans the data gathering takes the form of a demographic analysis of the participants in the plan. Using that information, we can then determine the most appropriate investment options. Our role on an ongoing basis includes education and advice to participants about plan, monitoring the plan results and providing wealth management services to the employees.

The retirement plan market is now bracing for a regulatory change from the Department of Labor (DOL) that will crack down on excessive fees and lack of transparency in retirement plans, effectively forcing all plan providers to catch up to our position. Obviously we view this as a positive development, one that will level the playing field. All participants deserve to know both the costs of their plan and the services they are entitled to receive.

The DOL first seeks to address the controversial practice of hiding fees paid to providers of qualified retirement plan services. Their regulation will require service providers to have a written contract with the plan fiduciaries that spells out their services as well as making detailed disclosures of all direct and indirect compensation and the potential conflicts of interest caused by these payments. Prior to this regulation, the burden of determining if the fees and services of a plan provider were “reasonable” fell primarily on plan fiduciaries.

Fiduciaries have a legal duty to ensure that a plan is always operated in the participants’ best interests; the lack of transparency in fee arrangements made this analysis difficult. Until now, service providers have not been obligated to provide this fee information in any kind of standardized format, making it impossible for plan fiduciaries to compare costs from provider to provider, to determine which provider’s services best match the plan’s needs and to protect the best interests of the plan’s participants.

The four main areas that the regulations address deal with written agreements, timely disclosures, fiduciary status and conflicts of interest.

Written Agreements: **The contract must be in writing and the contract must adequately describe all the services that are being provided under the agreement.** The agreement must describe all the services being provided under the agreement, not just those for which the service provider is specifically compensated.

Timely Disclosures: **Certain required information must be provided in advance of signing an agreement.** Information about all the services provided, any direct or indirect compensation received, and all potential conflicts of interest must be disclosed before a contract is entered into.

All direct and indirect compensation received by the service provider or any of their affiliates in connection with the agreement must be described. Compensation is defined as both money and any other thing of monetary value, such as gifts, awards and trips. It includes amounts received directly from the plan or indirectly from a source other than the

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plan (such as revenue sharing arrangements), and includes any compensation received by an affiliate in connection with the agreement.

Providers must disclose how the compensation is determined, and how it will be received. The agreement must disclose if the compensation is determined by a formula (for example, based on a percentage of plan assets or a per-participant charge), is a fixed amount, or any combination thereof.

Fiduciary Status: Service providers must disclose in advance whether they or any of their affiliates will provide any services to a plan as a fiduciary under either ERISA or the Investment Advisers Act of 1940. The rule applies to named fiduciaries and to persons who become fiduciaries by virtue of the services provided to the plan, such as providing investment advice. *The agreement should specifically name those services provided as a fiduciary and those provided as a non-fiduciary.*

Conflicts of Interest: A number of disclosures must be made that relate to possible conflicts of interest. Service providers must:

- disclose if they or their affiliates will have any financial or other interest in any plan transaction connected with the services they provide
- describe any material financial, referral or other relationship they have with various parties that may create a conflict of interest
- identify situations under which they can affect their own compensation without the prior approval of an independent plan fiduciary.
- disclose any policies they have that are designed to prevent any real or potential conflicts of interest.

Under the new guidelines, the plan sponsor (or employer) is now even more on the hook for plan compliance. The plan sponsor is the fiduciary to the plan. The broker or agent to the plan must be a “named fiduciary” or the responsibility, as well as the liability, to comply with the regulations falls upon the employer sponsoring the plan. The plan sponsor is required for their own protection to know how much is being paid, where it is coming from, whether it is a direct or indirect fee or payment and if it is “reasonable” to the market place.

Look for more next time as this goes into effect and please call if you have any questions on liability and exposure in your current plan.

INSIDE THE MARKETS

FRANCIS J. DAVIES III

We Have Met The Enemy...And He Looks Familiar

(This piece also appeared in the 9/28/08 Maine Sunday Telegram “Insight” section)

When President Bush introduced the Wall Street subsidy last Friday, he said that it was not the time for assigning blame. The public has had a week to ponder the implications of the starting price of \$700 billion and other uses for the money. We can either bail out Goldman Sachs or we can: repair every single bridge and road in our neglected infrastructure: fund

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Social Security; fund Medicare; improve public education; insure everyone's retirement and make alternative energy a reality. The next day we could provide healthcare for every single American and get a new knee for Tom Brady.

Something has to be done to address the financial crisis. We are being pressured to accept the Paulson plan immediately as if it were the only possible option when a better approach has already been used. In 1992, the banking system in Sweden collapsed under a pile of bad loans caused by a real estate bubble. The government stepped in, but not right away and they did not use the Paulson approach of buying the bad loans from the banks at inflated prices. Instead, the banks were forced to write down all of their losses before they got a dime of public money. When they received funds, it was in exchange for equity in the banks – so the public could participate in the return, not just shoulder the risk. They used capitalism. Like we did with AIG and Fannie Mae.

The largest bank, SEB, decided to fix its own balance sheet and turned a profit in 1993. Sweden is not a paragon of capitalism, but their banking bail out wound up costing very little. As a 26 year veteran of investing and trading, including 20 years with a large firm in NYC, I am a big believer in the free market and have a major issue with the government operating the financial sector. But I am also a big fan of what works. I trust reality over opinion. I also trust incentive based compensation over a free handout. Why does Warren Buffett's lousy \$5 billion get him a big piece of Goldman when our \$700 billion gets us toxic waste?

We could start by blaming the government for this, since they are paid to watch out for us. Which they might have done, except for the deregulation binge that started under Reagan, continued through Bush I and Clinton and carried on today by Bush II. This rush to deregulate gutted the SEC, abolished the Glass-Steagal Act and led to this mess. (Google away – it is all there.) So it is their fault - those Republican/Democratic administrations. Except that we Americans believe in less regulation, small government and free markets, don't we? The bad guys must be all those Wall Street types. We trust them with the keys and they drive the global economy into a ditch. Except, as noted above, we like our markets free and Wall Street exists to maximize profit. So it has to be sub-prime mortgages at the bottom of all this. But mortgages, sub-prime or otherwise, work out just fine as long as the borrower pays back the loan. Which would put the blame back on... hang on, I don't like the way this is headed. Let's start over. How did we get here?

Step one – the Housing Bubble. In 1938, Fannie Mae was started to create a secondary market for mortgages so lower income Americans could buy a house. In 1968, Fannie Mae was privatized, issued stock, and became a private corporation gambling public funds. Over the next 40 years, what was meant to be a small, special purpose agency grew to control 50% of the US mortgage market and issue roughly \$2 trillion in debt. All that money was loaned to home buyers, artificially pushing home prices higher. It became gospel that houses only went up in value, they didn't depreciate like other assets so stretching to buy as much house as was possible was darned smart.

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With their proceeds, Fannie Mae made a fortune and used a good portion of it to purchase the finest legislators. Predictably, they were regulated poorly if at all. One investigation found that Fannie Mae was taking on enormous risk by not adequately hedging for rising interest rates. In 2003, a plan to increase oversight of Fannie Mae and Freddie Mac was proposed by the anti-regulator - George W. Bush. (Didn't see that one coming – did you?) Home builders and Democrats killed it, saying it would reduce loans to the poor. Political side plots were also involved, but the additional supervision would have helped down the road.

Part two - Wall Street gets involved. Investment banks (IBs) make serious money buying and packaging mortgages, then slicing them up and selling the parts to institutions that need lots of fixed income (aka bonds) like insurance companies and banks. The IBs pushed mortgage banks to make more loans so they could make more money. This answers the fundamental question of why lenders made all these high risk loans – **because it wasn't their money.**

The slicing up part gets interesting. The mortgages were sorted according to quality, then cut into tranches which were numbered according to when they got paid. The first tranche received the initial payments, down to the last tranche which had the risk of being last in line but also had the potential for gain if there were extra funds at the end. The problem was, nobody wanted to buy the high risk stuff. Time for magic!

The IBs gathered the toxic tranches, bundled them, sliced them into tranches and created more bonds – called CDOs – the majority of which received AAA ratings. Highly risky debt magically became AAA rated bonds. The ratings companies deserve all kinds of blame. Their loan evaluations were based on data provided by the issuer from a time period when house values soared. Since that historical default rate was low, they assumed it would stay that way. Forever. The large brokers and banks sold CDOs to their clients and called them as good as cash. The State of Maine was sold \$20 million of this junk. (Mainsail II is the name to Google.) We were promised a refund from the firm that sold it to us. That firm has since been acquired. Hopefully we got our money back first.

Before all this mess started, we had a deal in America: work hard, save your money and you could afford to own your own home. It changed over time. Anyone could get a loan; everyone was buying houses and housing prices went sky high. Based on those escalating prices, people could afford even bigger loans. The deal mutated to: every American deserves to own a house, preferably 2500 square feet with big screen HD TVs in every room.

Spending was the new creed. After watching the restaurant where I courted my wife disappear in a dust cloud one September morning, I was told to shop. Spending would solve everything. For the last 20 years, US economic growth came from debt funded consumption. From 2002-2006 household borrowing grew 11% a year. We borrowed against our homes as well. Lenders say people spending 30% or more their income on housing are in trouble. That now applies to 38% of every American with a mortgage.

Will this rescue plan work? It will buy time for balance sheets to be repaired. But it has an essential flaw. It tries to maintain the status quo. Hank Paulson designed the plan to buy time

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and get the economy to “fund expansion”. We cannot afford what we have. The plan should really be to shrink the economy back to a sane level. Shrink the massive debt down to a level where earned income can support it. In 1978, American households had total debt that amounted to 79% of total employee compensation. Today, this figure has more than doubled to 174%.

We have met the enemy and he is us – our need for stuff, our reliance on experts, our unwillingness to sacrifice anything. We are an opinionated country. We would be much better served by becoming informed.

IMCG NEWS

FRED WILLIAMS: Recently returned from The Dream Factory’s National Board Meeting in St. Louis where he was again appointed to the organization’s Executive Committee and as Chair of its Finance Committee. The Dream Factory grants dreams for critically and chronically ill children nationwide, is based in Louisville, and has 2 chapters in Maine. Additional information can be found at www.dreamfactoryofmaine.org.

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