VIEWPOINTS

3RD QUARTER 2009 | ADVISORY NEWSLETTER

MARKET COMMENTARY — FREDRIC W. WILLIAMS

Où Est Poulet Petit?

Time flies when you're having fun – just twelve months ago we were in the throes of a full on financial melt down that would have surely vindicated Chicken Little and her acorn induced warning to the King about the falling sky. But once we got past the ides of March earlier this year it seems like Henny Penny and the rest of the devotees either skipped town or ran into Foxy Loxy as the markets have done nothing but go straight up since then. Whether fueled by stimulus liquidity, day trading, flash trading or irrationally optimistic exuberance, the domestic (and global) equity markets, that were recently believed to only have the capacity to decline, turned on a dime and surged 50% higher in about 6 months. At first glance this performance would seem to suggest that all the "bad stuff" that pushed the markets lower from October of 2007 to March of 2009 has been "fixed"…well, as my sons chirp to me periodically, we think the answer to that is "not so much".

While we do believe that the economic catharsis we are presently enduring will ultimately lead to a very gradual recovery in the economy, we're reluctant to believe that the root causes of all this financial pain have been addressed and resolved. From the still struggling housing market that was emblematic of the excessive leverage running rampant throughout our economy, to the massive number of people either un- or under-employed, or the lack of competent regulatory oversight that allowed many of the structural risks to grow, we don't think all the underlying issues have been fully corrected or that the economy is out of the woods to the degree the manic markets would like us to believe.

In just twelve months market participants have evolved from the deer-in-the-headlights panic to sell everything that's not nailed down, to resurgent day traders with bloodshot eyes from their hours at the computer committing all their cash to liquidity propelled momentum stocks and long-only futures driven commodities – all in the name of making sure they "catch the bounce".

This sentiment dynamic can best be seen when one views the chart of the VIX (Chicago Board of Exchange Volatility Index) which measures the prices investors are willing to pay for options to hedge positions in the equity markets. A rising VIX usually indicates investor unease in a declining market, while a declining VIX suggests a lessening of concern. After trading between 10 and 20 into mid 2007, the Dow and the S&P pushed to their record highs

later that year and was accompanied by a new trading range for the VIX of 20 to 30 until mid September – when the music stopped with the collapse of Lehman and AIG. At that point the VIX went straight to 80 and traded between 50 and 80 until the end of the year, which was then followed by a trading range of 40 to 50 until March – when the music started again. Since then the market has gone up and VIX has gone down, returning to the 20-30 range we saw two years ago, and is off 29% thus far from the more perilous environment earlier this year. This dramatic swing in investor sentiment is reflective of what has happened over the last 18 months – a pattern somewhat akin to a bungee jump: complete terror on the way down and then total euphoria on the way back up. One has to remember, however, that every "bounce" has two sides to it – and the challenge is to determine if the ascent or descent will be the prevalent trend.

As longer-term value oriented investors that focus on income generation, we believe that attention to fundamentals, rather than shorter term price swings, is the preferable strategy for prudent participation in the capital markets. If one can accept the notion that corporate profits are derived from sales of either goods or services to us as consumers, then one would think that our capacity to be purchasers would directly impact the revenue prospects for all manner of corporations and companies – large and small. We consumers have, or lack, confidence about our financial futures based on a number of variables. Two of the most significant being our employment and the condition of arguably one of our largest investments – our home.

As the headline number on unemployment heads toward 10%, the more significant measure looks at a broader swath of unemployed, underemployed and discouraged workers referred to as U-6 or the "augmented" unemployment rate.

> *"But the household survey, from which the unemployment rate is derived, found a 785,000 decline in employment, a huge drop seen only three times before in the entire postwar period, Stephanie Pomboy of MacroMavens finds. And the jobless-rate rise would have been bigger had it not been for a 521,000 contraction in the labor force, a dropout rate seen only five times in the postwar era, she adds. Add together the officially unemployed (those out of work but pounding the pavement), those working part-time because they can't find full-time work, and those who have given up looking, this comes to an "augmented" unemployment rate of 17%."* *R. Forsyth, Barron's 10/03/09*

On the housing front, the bubble is deflating at a less rapid rate as home builders curtail new construction to reduce inventory, while existing home sales have had their plummet somewhat mitigated by the allure of the federal tax credit. Unfortunately, much like the temporary jolt that "cash for clunkers" provided for summertime auto sales (September sales declined again once the program closed), we think that housing will suffer a similar fate when the home buyer stimulus sunsets at the end of November.

We think the post-steroidal reality of additional units from the shadow inventory of pending foreclosures and the continuing prospect for home owners in a weak economy to fall behind in their payments as option adjustable rate mortgages reset to significantly higher amounts, will present substantial headwinds to a sustainable recovery in the housing market.

Economics 101 taught us that is that if you have more supply than demand, prices will go down to coax buyers into purchasing. With August's existing home sales off a surprising 2.7%, Barron's cited an Amherst Securities commentary on the supply side of the equation. The report:

> *"…focuses on the swollen overhang, the so-called shadow inventory, that has grown inexorably in the wake of the tsunami of default and foreclosure. Amherst estimates this massive overhang at seven million units. That's the equivalent of 135% of a full year's existing-home sales and chillingly greater than the 1.27 million units that made up the overhang in early 2005, when the housing bubble had just begun its dizzying and more than a little lunatic ascent.*
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> *Put another way, of the 56 million units that the Mortgage Bankers Association says make up the mortgage universe, Amherst gauges 6.94 million units are in what it dubs the "delinquency pipeline" eventually headed for liquidation. And it reckons that another 300,000 mortgages replenish that unwelcome flow every month.*
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> *Essentially, then, this shadow inventory represents a massive furtive supply of future foreclosure. Amherst fingers negative equity as keeping the delinquency pipeline heavily stocked. Quite a reasonable assumption, we think. A home owner, saddled with a house that's valued at less than it cost him to buy or that he can reasonably expect to sell it for may lack the will and, more importantly, the wherewithal to keep making payments on his mortgage."*
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> *A. Abelson, Barron's 09/28/09*

As we have discussed in the past, one of the causative factors in the housing implosion has been the use of unrealistic teaser loans that were sold based on the fallacy of continually rising real estate prices. With prices now declining, the mortgage holder has been put in the position of retaining, rather than flipping, said real estate and is thereby forced to face the music of actually making the true amortized payments. This combination of declining values and increasing mortgage costs has been a significant issue facing the housing market and doesn't appear to be abating anytime soon. A Washington Post column noted a recently released Fitch Ratings report:

> *"Option ARMs, also called pick-a-pay loans, allow borrowers to choose how much to pay each month. Nearly all the borrowers who took out this type of loan from 2004 to 2007 chose to pay less than the interest due. Sometimes they paid as little as 1 percent interest. But the loans eventually require the borrowers to start paying the principal and full interest rate, so the payments shoot up.*
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> *In its report, Fitch estimates that $134 billion in option ARMs will reset in the next two years. It expects monthly payments to jump 63 percent on average, or $1,053 a month, for loans adjusting this year and next, prompting a rise in defaults and foreclosures.*
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> *At the root of the problem is that many who took out option ARMs were betting that home prices would rise. The loans helped people buy homes at a time when prices surged to unprecedented highs. As long as home prices kept climbing, these borrowers could refinance before their loans adjusted. But once prices tumbled, that option vanished. Now many people cannot refinance because they owe more than their homes were worth." 09/09/2009*

As we've indicated previously, consumers represent nearly 70% of our domestic GDP – if they are not having their wallets filled via employment, or see their home equity loan/ATM capabilities curtailed due to declining real estate values, we would expect them to hunker

down on the spending side of the equation. Not that debt reduction and savings is a bad thing, it's just that it will occur at the expense of, rather than contributing to, corporate and business revenues.

As noted last quarter, we're confident that eventually we will see a gradual recovery that will include significant deleveraging throughout our entire economy. We just question if the straight line trajectory of the markets is consistent with what we see as a more gradual and bumpy progression toward improving economic activity.

> *"The biggest letdown for the stock market was a string of economic disappointments. Manufacturing had been a bright spot, but the Institute for Supply Management reported that its index of business activity fell to 52.6 in September from 52.9 in August.*
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> *Friday's employment numbers were much bleaker than expected, with the unemployment rate jumping to 9.8% last month and employers cutting 263,000 jobs. The average workweek declined to a postwar low of 33 hours, suggesting that businesses may not need to ramp up hiring soon."* *WSJ 10/05/09*

Eventually the jobs market will improve just as the housing and real estate markets will with the rest of the economy. As we said earlier this year, the various stimulus programs are doing their job, and we have dodged any potential escalation to Depression 2.0. But since there's a decent possibility that the gradual economic recovery could resemble a letter other than the "V" posted thus far by the equity markets, we think prudent investors should continue to be cautious, gradually deploying capital as opportunities present themselves. In the race between the tortoise and the hare we're all familiar with who the winner was – a more important distinction may be that the average life of a hare is 2 years while that of the tortoise is 120. As you can imagine, we're more comfortable to not be in a rush.

EQUITY MARKET OVERVIEW — INVESTMENT POLICY COMMITTEE

More Rocket Fuel, Por Favor…

The near vertical lift off from the March 9 lows continued in the 3rd quarter as domestic equity markets printed an impressive tape over the last three months. In fact, the moon-shot recovery in prices was mirrored almost universally as global capital markets, awash in central bank induced liquidity, threw money at financial assets thinking they had to nail THE bottom after the late 2008 early 2009 melt down. Much like spring-breakers consuming liquid courage prior to their next beach adventure, traders threw caution to the wind and bid up prices of the riskier companies first and furthest. As was pointed out in the preceding column, it's sometimes difficult to remember that consensus sentiment less than a year ago had the world perched on the precipice of financial Armageddon – how quickly things have appeared to change.

Second quarter momentum continued to push stocks higher with the DJIA up 15% for the third quarter of 2009 (its best since Q4 '98 and the best 3rd quarter since 1939) and entered the last lap up 11% year to date. The S&P 500 also rose 15% in Q3, up 17% on a year to date basis and benefiting from a greater exposure to the financial sector, while the NASDAQ kept up its torrid pace with a 15.7% increase, starting the last quarter of 2009 up 34.6% for the

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year. Left in the dust by the re-emerging day traders were more conservative total return sectors like utilities (the DJUA is only up 1.7% year to date) as they migrated capital to higher beta holdings to appease their new found risk appetite. Although still down around 31% from their October '07 highs, the Dow and S&P have posted a nearly 50% recovery from the March 9th 2009 lows.

Our concern with the markets is not with the trend but instead with the magnitude of the move and the timeframe within which it has occurred. Recognizing that the globe has been awash in cash as a variety of stimulus programs began to have an impact during the 3rd quarter, we're skeptical that absent the dizzying array of financial steroids the markets have been "on" that they can continue to be disconnected from the reality of the overall economy. As we've opined in this space in the past, with more than two thirds of GDP a function of consumer activity, jobless consumers are not likely to provide positive contributions to that calculation.

> *"Our own favorite measure of unemployment is, as we've noted more than once before, is good old U-6, which reached a new peak of 17%, up from 16.8% the previous month (and 10.6% a year earlier). U-6 includes part-timers who lust after a full-time job but can't find one, along with, as the BLS dubs them, "marginally attached workers." Actually, that's a wonderful description, conjuring up, as it does, the image of folks hanging by a thread...there are 2.2 million of these marginally attached souls, who would like to work but haven't been able to land a job and aren't receiving benefits. Add in some 9.2 million involuntary part-timers and the aforementioned 15.1 million formally unemployed, and the jobless total swells to over 26 million…what those dry-as-dust dry statistics mean…are 26 million people not going to malls for extras, or taking the kids to the movies, hunting the cheapest victuals they can find at the supermarket and who are denying themselves the pleasures of travel, eating out, upgrading to Windows 7 or buying iPhone apps…The ironic conclusion…is that corporate revenues are destined to continue to drag, and companies straining to realize those absurdly inflated Street expectations for 2010-11 earnings will continue to focus on cutting costs, which translates into cutting jobs."* *A. Abelson Barron's 10/03/09*

Overseas markets for the most part did modestly better, with the developing world retaining bragging rights over the developed markets, albeit at a slower pace than during the 2nd quarter, but none the less posting impressive year to date results.

London's FTSE 100 rallied 21% in the quarter, up 15.8% year to date, with similar results at its Euro-based counterparts as Frankfurt's DAX was up another 18%, leaving it up 18% year to date, and the Paris CAC 40 climbed 21% (up 17.9% YTD). Tokyo's Nikkei lagged during the quarter, the result of a change in government and a stronger yen, rising only 1.8% for Q3 but still up a respectable 14.4% as we start the fourth quarter.

The developing world continued its march higher, although at a slower pace than in the second quarter, with Bombay's Sensex adding 18% in the quarter (up 77.5% YTD), Turkey's National ISE up 30% (68% YTD), Russia's RTS climbing 27% (83% YTD) and Brazil's Bovespa [the recently announced home to the 2016 Summer Olympics] increasing 20% in Q3 to hit the start of the 4th quarter up 63.8%. China's Shanghai Composite was a rare weak

spot, declining 6.1% in the quarter, but still up 52.6% on a year to date basis. Over the longer term we would expect the emerging markets, given that the developing world represents nearly 80% of the globes population, to present significant growth opportunities. Not only are these countries, for the most part, morphing from merely low-cost labor exporters to societies of sustainable consumers, but their significantly younger average age bodes well for that trend to continue for the foreseeable future.

Although constructive on the longer term prognosis for a gradual economic recovery, we are less sanguine about the nearer term prospects for the domestic markets as we feel they have gotten ahead of themselves. Discounting future improvements realized from the recovery is one thing, ignoring the fundamentals of what underlies it may have to be done at ones peril. We believe that certain sectors offer reasonable long term total return opportunities, but chasing liquidity driven prices solely because they have levitated in six months is not an area within which we chose to tread. We also can envision an environment where cash equivalents can be quite valuable in a bottoming process, as it's rare that there's merely "one" bottom during a period of such severe financial stress. Continued market unease can create attractive income producing total return opportunities for disciplined investors making rational, rather that emotional, asset allocations decisions.

BOND MARKET OVERVIEW — INVESTMENT POLICY COMMITTEE

The Thaw Continues…

Compared to the iced-up conditions of just under a year ago, the bond market continued to slowly improve during the third quarter with credit spreads narrowing as investors came out of the money market bomb shelter with a desire to put cash to work rather than worry about the prognosis for the economy.

With the F.O.M.C.-controlled rates unchanged for the quarter (Fed funds remained targeted at 0% to 0.25%) corporate debt improved in price as the consensus began to acknowledge that not every company on the planet was on the verge of insolvency. Treasuries reversed a bit of their second quarter decline thanks to the return of foreign demand, as well as Fed backing the truck up and expanding its balance sheet by loading up on additional Treasury issuance.

> "*Holders of U.S. government bonds overcame worries that foreign central banks would scale back purchases. Strong interest from overseas investors, coupled with purchases of Treasurys and mortgage-backed securities by the Federal Reserve, helped support bond prices and keep yields and home-mortgage rates low…The yield on the 10-year Treasury note was 3.309% at the end of September, after touching a high of 3.852% in the third quarter. The 10-year yield was 3.521% at the end of June and remains well above its closing low of 2.078% last December, when investors fled to havens amid the financial crisis.*" *WSJ 10/01/09*

The real "melt up" in prices once again this quarter was in the junk market – trash was king, much like during that hallowed period on Wall Street in the 80's that was memorialized in "Barbarians at the Gate". The 3rd quarter saw spreads over Treasuries close by more that 30%

(from 10.6 percentage points to 7.9) resulting in year-to-date record gains of 48% in the junk bond market.

With most of the world's central banks drinking the same accommodative cool aid, global bond markets benefited from the diminishment of fear in a continuing low-interest rate environment. In fact, maintaining this relatively low-yield environment is one of the last tools available to the Fed as they buy time so the credit markets can become functional once again. Absent any uptick in short term rates yielding next to nothing on cash equivalents, fixed income investors are being compelled into a forced march out in maturity and down in credit quality. To a certain extent, the longer the Fed can maintain this stasis, the better.

As one can imagine, the flies in this ointment are numerous, and potentially onerous. Given that one of the best investments in the last year may have been in the green ink used to print dollars, the most significant friction point may in the relative value of the U.S. currency. Combining the abundance of greenbacks in circulation with the Fed's stated intent to begin withdrawing from the quantitative easing policy of purchasing Treasuries, it becomes clear that the currency markets could push the dollar lower and/or higher interest rates may be demanded by the purchasers of our debt. Although the specter of higher interest and inflation rates have yet to be visible, that doesn't mean they aren't a downside risk to be cognizant of as a bond market investor.

Much like the recognition that consumers went on a borrowing binge that they need to deleverage from, the same observation may have to be made about our country's overall debt when compared to our gross domestic product.

> "*For instance, the ratio of debt to GDP for all levels of government debt is 87%. But if you add household and business debt along with the GSE (government-sponsored enterprises) like Fannie and Freddie, the ratio rises to 331%. If you add in future benefits of Social Security and Medicare, the number becomes more like 1,000%...we can run large deficits almost forever, as long as the deficits are less than nominal GDP. While it may not be the wise thing to do, it does not bring down the system. But when you start adding to the deficit in amounts significantly larger than nominal GDP, there is a limit…The current political class and their intentions are dangerously close to killing the golden goose. It is one thing to steal the eggs; it is an altogether different thing to kill the goose through ignorance of the consequences. And the size of the deficit, for as long as they plan to have it, will most assuredly kill the goose… there will come a point when the party is over. Interest rates on the long end will rise precipitously, forcing mortgages up and making the deficit even worse.*"
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> *J. Mauldin 10/2/09*

Although the present administration's wager is that the stimulus punchbowl can be adroitly withdrawn from the party *after* jump starting the economy and *prior* to any adverse impact on interest rates and inflation, we're compelled to feel that the "new normal" of slower growth in a deleveraging environment is going to extend the duration of the eventual recovery. We don't begrudge the bond market's rally as we felt that like the equity market early this year, the downside move was overdone. What we take umbrage with going forward is that we see the downside risk of rising interest rates to be a more likely threat to the bond market over the next 5 to 7 years, something that compels us to keep our maturities shorter,

our currencies diversified and our instruments amply exposed to inflation hedged and protected structures.

WEALTH MANAGEMENT UPDATE

Social Security Strategies TRACY W. ROGERS

With recent market declines, many people have had their retirement savings substantially reduced. With less retirement savings, the viability of Social Security has become more important than ever for both younger and older employees. Couple this with existing retirees not getting a cost of living adjustment (COLA) next year and it only exacerbates the problem.

Up until 1975, it took an act of Congress to adjust Social Security payments for inflation. A law enacted in 1972 created a formula to automatically calculate a COLA every year. This COLA was tied to the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W). Every year since it was put into effect it has resulted in an increase. High oil prices contributed to a sizable increase last year of 5.8%, the highest in 25 years. This year the CPI-W is expected to decrease, due largely to declining oil prices. While Social Security cannot be adjusted downward for a declining CPI-W, it is rumored that there will be no COLA increase for 2010 and 2011.

With COLA adjustments and Social Security changes likely, what should you do to maximize your retirement income? If you are under 50, plan for your retirement as if Social Security may be reduced (i.e. save more). If you are older than 50, your Social Security benefits will likely be unaffected by any future changes. However, since the Social Security rules are so complex, be sure you understand all of the variables before you begin taking benefits. As an example, many people believe that if they are fully retired, they should automatically begin taking Social Security benefits at age 62. This decision, however, could cost them thousands of dollars in reduced benefits.

Strategies on When to Take Social Security Benefits

Strategy 1_– If you will have any meaningful employment between age 62 and your Full Retirement Age (FRA), wait until your FRA to begin your Social Security benefits. FRA is defined as 65 for people born between 1939 and 1959, and 67 for people born after 1959. Be aware that any meaningful employment income above $14,160 annually will reduce your Social Security benefits by one dollar for every two dollars that you earn above that limit.

The next two strategies assume that you are in good health and that you do not require early Social Security benefits for your financial survival.

Strategy 2 – Even if you are fully retired, start taking your Social Security benefits at your FRA (instead of age 62) if you don't need the money right away. By doing this: 1) You receive annual Inflation adjustments based on benefits that are 33 percent higher; 2) You receive more total benefits if you live beyond age 77 and 3) If your benefits are greater than

your spouse's and you pass away before your spouse, your spouse can receive a 33 percent larger payment.

Strategy 3 – If your spouse is younger and will receive a significantly lower benefit, consider waiting until age 70 to collect your benefits. This will provide you with a benefit that is 32 percent greater than your FRA benefit and at least 76 percent higher than your age 62 benefit. More importantly, if you die before your spouse, he or she will receive this increased benefit for the remainder of their lifetime, if they wait until their FRA to begin taking Social Security benefits.

These next two little known approaches are available only if you've reached FRA – (65, gradually increasing to 67). They are not widely used, so far. One reason is that most people begin claiming Social Security at the earliest eligible age, 62 (before FRA), and that number has spiked in recent months as people face financial pressure. If you or your spouse can hold off until full retirement age, the benefits may be significant.

Strategy 4- Claim and suspend- If you've already started collecting Social Security but don't need the money now, you can change your mind, thanks to a little-known provision called "claim and suspend." That is, once you've claimed your benefits, you can turn around and suspend them for as long as you like. Claiming and suspending may add to your bottom line in three ways:

- First, by signing up for Social Security, your spouse can also claim a spousal benefit, which typically is about 50 percent of yours. (The spousal benefit continues even if you suspend.)
- Also, by suspending, then delaying your own benefit, the amount you'll eventually receive each month continues to grow at 8 percent a year, until you've hit 70.
- And, if you die first, the higher benefit is passed on.

Only Social Security recipients who are of FRA and have never collected early benefits can use the "claim-and-suspend" strategy.

Strategy 5- Claim now, claim more later - This strategy works for married couples who claim benefits based on their own work record. If one of you has taken your benefit, the other can draw a spousal benefit, typically around 50 percent, even while continuing to work.
It works like this: If your husband (or wife) is receiving a benefit and you have reached FRA, you could claim a spousal benefit, rather than your own. You typically would get about half of what your spouse receives. Meanwhile, your own retirement benefit continues to grow at 8 percent a year. When you reach 70 (when the amount no longer qualifies for the annual increase), you could switch from a spousal benefit to claim your own benefit, if it's larger.

These strategies were included in the Senior Citizens Freedom to Work Act of 2000, passed to encourage people to continue working beyond their retirement age. One way to achieve that, explained Patricia Dilley, professor of law at the University of Florida and a former staffer on the House Social Security subcommittee, was to allow people to access some level of retirement benefits while they stayed on the job.

As you can see the decision to on when to take Social Security benefits can be quite daunting and the rules very complex. There are many strategies just to figure out how to draw down retirement assets (IRA's) and their impact on your taxes. Now more then ever it may be time to look at how the market decline may have changed your plan on when and how to take benefits. This may be a good time to reevaluate the strategies with IMCG and your tax advisor.

What's the State of Your College Savings? TRAVIS SPENCER

According to the College Board, the nationwide average annual cost of a four-year public university for in-state residents is $14,333 and $34,132 for a private university. These costs are increasing at roughly 6% a year. To make things worse, the value of the average college savings plans dropped 21% in 2008. Many people don't qualify for full financial aid so they have to rely on a college savings plan in part to help offset the cost of sending their kids to school. So the hundred-thousand-dollar question (literally) becomes "how do I go about accumulating as much as possible as quickly as possible in my college savings plan?"

When it comes to college savings there are many options: 529's, ESA's, IRA's, UTMA's, UGMA's, savings bonds and trusts'. Lots of acronyms. Very confusing. For our purposes this quarter, let's focus on 529 plans, the many choices offered, and what things you should consider when selecting the right 529 plan for your situation.

The basics (nicely summarized at the **savingforcollege.com** website):

- 529 Plans are Tax Efficient - 529 Plans operate most similarly to a Roth IRA – contributions are made from post-tax dollar, but grow tax-free and distributions (i.e. withdrawal to pay that not insignificant college tuition bill) are also tax-free.

- 529 Plans offer Great Benefits – Federal tax benefits, state tax benefits, donor retains control of the funds, low maintenance, simplified tax reporting, flexible, substantial deposits allowed, and even some special estate planning features for grandparents who want to help their grandkids out.

Making an educated 529 purchase can have huge implications on your balances over the long term. The difference in plan fees, the difference in plan options, and differences in how the plan is purchased can impact your balances by *tens of thousands of dollars*.

For starters, each state offers a 529 plan option. The important thing to remember is that *you can join any plan you want, sponsored by any state you want*. It is just a matter of looking at the features and benefits each state offers with their program. It doesn't matter what state you live in or where your student ultimately matriculates. However, human nature tells us that we're most likely to look at the 529 plan sponsored by the state in which we reside, and if there is a local solution available we tend not to dig any deeper. Here's where it gets

interesting. The old Smokey Robinson song (later covered by, gulp, Captain and Tennille) says it best: “You better shop around.”

For the most part, states affiliate themselves with an investment brokerage company or two to manage the plan and offer the investment fund options (i.e. Maine has aligned with Merrill Lynch; Virginia uses American Funds, etc.). A few states have taken a more independent approach and manage the 529 plan themselves.

So why is there such a discrepancy from state to state and plan to plan, and why does it make sense to shop around?

1. According to Morningstar, 31% of all the mutual funds in 529 plans charge less than 50 basis points (1/2%), while 44% charge 100 basis points (1%) or more. That difference alone can equate to thousands of dollars over 18 years.

2. Each state offers two forms of their plan:
    a. Commission-based: sold by a commissioned broker, who hopefully advises you, and who usually has an affiliation with the investment company managing the plan.
    b. Direct: a “direct” plan - you go on-line, print off the forms, fill them out yourself, and pick your own investment options.
    c. The cost differences of using a broker versus going direct can also be in the thousands of dollars over 18 years.

3. Each state has different parameters it can set regarding maximum allowable contributions, and in some instances, how the funds can be used. Potentially huge tax implications over the lifetime of the 529.

Also important, most states now will give tax breaks to individuals under a certain income level, regardless of what state plan they use, or offer grants, or even “free money” to residents that have children (for instance, the state of Maine has implemented an Alfond Scholarship for all babies born after January 1, 2009 - just fill out the application and you get $500 deposited to your account, without you adding anything). We view these types of programs like a 401(k) company match. Our advice is to take advantage of the “free money” where it is offered, but to look for better options elsewhere for the rest of our 529 investments.

No matter which option selected, beware conflicts of interest.

- Each state wants you to invest in their plan because they get a piece of the pie - most states get a slice of the management fee from the fund assets (which comes in the form of a percentage of assets or a flat fee charged to the management company).
- The company managing the plan has a vested interest because they get fees and usually are using their own funds.
- Finally, the commissioned broker has an interest because he is getting paid to sell you that plan. You are theoretically paying for the broker’s advice.

Unfortunately good advice isn't always guaranteed. For instance, in the state of Maine in 2008, the most conservative option had 90% of its assets in Oppenheimer Bond funds and lost 19%. Oppenheimer funds has since been probed by five states in regards to risk they took on their bond investments and the fact that the clients were unaware of this risk and thought they were in a "safe" investment as their children approached college – yet another reason to choose wisely.

529 plans are a great college savings vehicle. They allow you to put away a larger sum of money compared to other college savings options, they grow tax free, and the withdrawals are tax free if used for higher education expenses. At IMCG, we bring our clients an independent voice that truly has their best interests in mind. We are there to talk strategy about the different college savings options available, the different 529 plans available, and whether the plans fit your (and our) forward-looking strategies.

INSIDE THE MARKETS

FRANCIS J. DAVIES III

Saving Capitalism, part two.

"We will not go back to the days of reckless behavior and unchecked excess at the heart of this crisis…There are some in the financial industry who are misreading this moment. Instead of learning the lessons of Lehman and the crisis from which we are still recovering, they are choosing to ignore them. They do so not just at their own peril, but at our nation's…It is incumbent on us to put in place those reforms that will prevent this crisis from ever happening again."

President Barack Obama made the above comments on September 14, 2009 in a speech to Wall Street marking the one-year anniversary of the failure of Lehman Brothers. One year after modern day's largest market collapse, what has really changed? Very little. It is, as the saying goes, "business as usual" on Wall Street. The public remains on the hook for any future disasters, yet receives little information outside the simplistic right wing and left wing ranting. It is a complicated issue that requires thoughtful discussion.

A typical and very human reaction to a crisis is once the immediacy of the threat has passed and we personally no longer feel in danger, we move on to the next issue. A year ago the financial world was ending. It was dead on the gurney until shocked back to life by unimaginably massive amounts of our money. Among the carnage: Lehman Brothers went bankrupt; Bank of America had a gun held to its head and was forced to acquire Merrill Lynch in a real life shotgun ceremony and AIG was rescued from default. Later we found out that a big chunk of the money paid to save AIG went to Goldman Sachs.

The markets have improved dramatically (as we suggested they might), economic numbers are improving, and Americans are getting back into the normal grind. The demand for change and reform has quieted down to a faint murmur. It seems like the moment has been lost and with it any momentum for the type of regulation that could prevent this type of financial collapse from occurring again. There is no doubt that effective regulation would be

complicated, politically dangerous and very unpopular. We may never trust Wall Street again, but on the whole, we trust the government even less.

Last quarter, I discussed two of the more obvious schools of thought in the capitalism vs. regulation battle. Keynesian economics states that private sector decisions can sometime lead to inefficient outcomes, such as speculative bubbles, and should be controlled by regulatory bodies. Countering that is a viewpoint that believes just as strongly in less government interference, a return to laissez-faire capitalism. This school of thought includes most businesspeople, the former Fed chairman Alan Greenspan and the Libertarian icon, Ayn Rand. These brave souls seek a return to the golden age of unfettered American capitalism, when we ruled the global economy.

Neither approach can work in the complex, rapidly changing world of today's markets. Both are based on simplistic assumptions and both lead to dangerous, unintended consequences. We saw the destructive effects of unfettered capitalism a year ago. Unfortunately, the words "effective" and "regulation" are rarely found in the same sentence. We need regulators that are as smart as the investment wizards, but compensation makes that impossible. Not all innovation is good, particularly when it comes to financial products. Our government is based on a system of checks and balances. In the same, way we need government oversight to balance the economic self-indulgence found in the marketplace.

The major risk we all still confront is "too big to fail." I am sure you are all familiar with that phrase. It was applied to AIG, GM and Fannie Mae a year ago. It could just as easily apply to Citicorp or Goldman Sachs sometime in the future. Despite my pro-capitalist leaning, I do not see a way to protect ourselves without some regulation. The Obama administration has proposed an overhaul that would close loopholes in regulation, set up a "systemic risk" council to oversee banks and investment firms considered too big or important to fail and find a way to close large financial institutions without threatening the broader economy. They would also set up an agency specifically designed to protect consumers from predatory loans and other financial abuses.

Anyone looking at that welter of new government agencies would naturally run for the exits. We can all imagine the potential for bureaucratic blundering. Sen. Judd Gregg, R-N.H., has said that the overhaul would "undermine risk-taking, capital formation and entrepreneurship and ... hurt job growth and American competitiveness." The mayor of New York, Michael Bloomberg, had a less dogmatic opinion. "The devil's in the details of what Congress does," he said. In the past, "Congress has been unwilling to change regulation because too many of them rely on campaign donations from a variety of people they regulate." Before he became a politician, Mr. Bloomberg started a company that became a vital part of the investment industry by supplying it with time-sensitive, critical information. He knows the business better than most.

The events of last year proved that what the public doesn't know *can* hurt it. Unless investors have someone working on their behalf, navigating these waters, they could get hurt. If the government cannot fill that role, then they need unbiased advisors to keep them from getting snarled in the next Wall Street shell game. It is a difficult balance – but if capitalism is to be

the economic model of the future, we need to try to get it right. Part of the answer may come from returning to the discarded rules of the past, such as government guarantees only for the deposits of chartered banks and the return of Glass-Steagal separating consumer deposits from financial speculation.

Executive compensation has to return to rewarding long-term results from the current practice of paying immediate bonuses for specious short-term gains. One way to correct this is to emulate the Wall Street partnership structure that worked so well for 200 years. Peter Weinberg, a former partner of Goldman Sachs, wrote an interesting editorial in the October 1st Wall Street Journal. Mr. Weinberg reminds us that up until 1970, the New York Stock Exchange did not allow brokerage firms to be publicly traded companies. The building of the modern American economy was financed by private partnerships such as Kuhn Loeb, Kidder Peabody, Dillon Read, E. F. Hutton and Drexel Burnham. Many of the old line firms disappeared in the blizzard of takeovers and mergers that began when Salomon became the first big firm to go public in 1981.

The partners at these firms had personal liability for the exposure of the firm. They were paid a salary plus bonuses paid out in increments until their retirement. In the 1980s, partners on Wall Street had base salaries of around $100-150K/year. A very nice living, but not multiples of what a good rainmaking lawyer or a surgeon made. They did well, but the amounts were not the obscenities we see today.

The main effect of turning a partnership into a public corporation was to transfer the financial risk to the shareholders and allow compensation to soar. A firm owned by the employees would not lever its balance sheet 35 to 1, buy $50 billion in mezzanine C.D.O.s and pay an $85 million bonus to the employee that constructed the house of cards. When compensation is tied to how an investment performs over its lifetime and there is personal liability for firm losses, the parties involved are forced to be prudent in their actions.

In the same way, the government safety net should never have bailed out AIG or any other investment firm. A government guarantee of assets should only apply to firms that are strictly regulated, like charted banks. Firms that chose to borrow excessively to purchase illiquid assets would be on their own dime. This would be reflected in their borrowing costs. AIG, Lehman, Merrill and Bear should never have had AAA ratings with their leverage and holdings. Their bonds should have had ratings and yields commensurate with the risk hidden in their balance sheets. Limited access to capital might limit speculation.

Free markets function by balancing risk with reward. The ultimate risk – total loss, bankruptcy, both corporate and personal – needs to be part of that equation. We need to let the market do its job of determining an appropriate level of return without the taxpayer's thumb on the scale.

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In the Client's Best Interest...

For anyone in our business it is a self-explanatory phrase: As a fiduciary and Registered Investment Advisor (RIA), IMCG is obligated to act in our client's best interest when making decisions regarding their objectives and assets. This is particularly important when we are working as a consultant for plan sponsors regarding their corporate retirement plans - 401(k), profit sharing, defined benefit, etc. Other so-called retirement plan "consultants" (let's face it – everyone refers to themselves as a consultant these days…) that operate under the non-RIA Broker-Dealer banner are only required to do what is deemed "reasonable" when making the same decisions. That is a very important distinction.

(Interestingly enough, Washington has taken an interest in the debate. Because of the recent economic and market meltdown, there is now a move afoot in the White House to hold Broker-Dealers to the same fiduciary standards that RIA's are required to uphold.)

"Really? What's the big deal? You're actually going to write an article about this?" you ask. Yes. As an RIA we feel very strongly about our obligations to our clients. We have built our company around the premise of adding value while doing what is right for the client. And that doesn't mean doing only what is reasonable. We always take the extra step (this is the part of the discussion where our competitors utter phrases like "it's just semantics", "those are insignificant differences", "we can do everything that they do", and "forget that, check our references"). The issue at the heart of this is that "best interest" has a lot less gray area than "reasonable", and it's usually all about the money.

Take for instance, plan fee costs: according to the Spring 2009 Deloitte study of all-in plan costs commissioned by the Investment Company Institute, the average annual all-in cost for a 25 participant/$1,000,000 401(k) plan was 189 basis points (1.89% of assets). The all-in fee includes fund expense costs, recordkeeping costs, education costs, and consulting costs. A Broker-Dealer could legitimately propose a new platform solution containing an all-in fee of 2.00% which would be considered "reasonable".

But what if there are platform and vendor solutions available that would fit the plan sponsor better, cost less than 1.50% all-in, and would include services not provided by the Broker-Dealer or the Broker Dealer's platform? (Hint: there are). We, the RIA, have a fiduciary obligation to put the best solutions in front of the client. They, the Broker-Dealer, are not held to the same standard (hence Washington's interest). Shouldn't the client's best interest be the motivation not "how much money will I make from the sale?"

Regarding sales, in the Broker-Dealer world, if a platform or vendor ceases to be a viable solution (let's say the company managing the "guaranteed" fund fails, as occurred in the late 1980's), the Broker-Dealer usually substitutes it with a platform that can replace the Broker-Dealer's income stream. This is what we call a "***conflict of interest***". Broker-Dealers are often paid a finder's fee for moving business, on top of what they take out of the account on an annual basis. How can you be making well-reasoned fiduciary decisions when you are

paid by the product you are selling? Hopefully, you can see the gap between the "client's best interest" (RIA) and "reasonable" (Broker-Dealer) models.

(Not surprisingly, there is a pushback to any potential White House-backed legislation and a very strong lobby from the "reasonable" crowd.)

There is a lot more to providing true fiduciary advice (that which considers the client's best interests) for retirement plans than determining that fees are "reasonable" and that historical Morningstar ratings and a plethora of fund options are the right solution for fund lineups. True fiduciary advice:

- Includes the consultant as a named fiduciary
- Means that the consultant does not receive payment from any platform, product or vendor.
- Dictates that the consultant will provide forward-looking advice on the proper investment policy, fund lineup, ongoing fund monitoring, and education program for your plans, and place them with the providers that best fit your needs.
- Means that vendors and platforms do not make critical decisions for clients. That is what you pay an RIA plan consultant to do.
- Given properly, will have improved the plan's fund options, reduced plan expenses, enhanced the plan platform offering and provided piece of mind that allows them to focus on their company business.

If your business has a retirement plan, or if you are part of a plan that could use true fiduciary advice that is in your best interests, consider calling IMCG and our qualified plan consultants.

IMCG NEWS

FRED WILLIAMS – Returned from the Dream Factory's National Convention in Florida where he was elected to another term on the Executive Committee as well as Chair of the Finance Committee. Every three years chapters from all over the country gather in Kissimmee to meet at Give Kids The World (www.gktw.org) where numerous Maine families have had their children's Disney Dreams granted. Fred is one of three Mainers to have been presented with a named paver on the Avenue of Angels (Along with Portland Chapter Founder Skip Welch and another long time Board member Mark St. Germain).

Additionally, he was also recently appointed to Chair the Investment Committee at Opportunity Farm for Boys and Girls in New Gloucester, Maine.

***TRACY ROGERS* -** Was recently appointed to the Investment Committee at MAPS Adoption & Humanitarian Aid. Part of Tracy's initial responsibilities will initially include the endowment and residential program funding efforts. MAPS is a multi-service, non-profit organization serving children and families worldwide.

***TERRY DAVIES* -** Has recently completed the second level in the four-part process to become a Certified Divorce Financial Analyst. The Institute for Divorce Financial Analysts™ (IDFA™) is the premier national organization dedicated to the certification, education and promotion of the use of financial professionals in the divorce arena.

In June, Terry was reelected to the board of Preble Street, an agency in Portland that addresses homelessness, housing, hunger, and poverty. In January, as part of the "Housing First" initiative, Preble will open Florence House, a facility that will provide permanent housing to 60 homeless women. To learn more, please visit: http://www.preblestreet.org/wishlist.php

***STEVE EDDY* –** Continues to serve as Treasurer of the Day One Board and was reappointed to the Maine Cancer Foundation Board. He was recently appointed to the Executive Committee of the Institute for Civic Leadership's Alumni Council, and will again coach the Scarborough Girls Tennis Team next year.

IMCG SEMINARS & EVENTS:

> ***MID NOVEMBER*** – *THE PORTLAND COUNTRY CLUB:* **"The Post Stimulus Economy – Where Will The Opportunities Reside?"** – A discussion about the economy and capital markets, focusing on what prudent long term investors should do to properly align their portfolio allocations and financial plans with the current environment. Seating is limited so please reserve space by calling 800.605.6552 or via e-mail to admin@imcgrp.com.