INVESTMENT MANAGEMENT & CONSULTING GROUP

VIEWPOINTS

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MARKET COMMENTARY FREDRIC W. WILLIAMS

Macro Reset Button…

Having inched back from the precipice we found the globe's markets clinging to a year ago, the absence of daily market and economic drama (save for the occasional politically motivated fiscal blip) is providing the opportunity for a longer term perspective about the implications for a world wide financial recalibration that we may see going forward. Although a nascent recovery will slowly be evolving, the experiential implications for those who weathered the storm, along with the oft-mentioned deleveraging process, will likely have a lengthy impact on how the world's economies and markets perform into the future. As we've noted in these columns in the past, the extraordinary use of leverage as the bubble was expanding, along with the resulting forced deleveraging process after the balloon popped, are central actors in the theatrics that played out over the last several years. And there's no doubt that we're only in the first few innings of the overall debt reduction game, given recent consumer activity and the eventual unwinding of the stimulus expenditures that central governments initiated to resuscitate the global economy. What's not yet fully understood is how broad, and deep, the impact of this hitting of the reset button dynamic may end up being.

The most prominent poster child for the excessive use of leverage has been the real estate market and the mortgage shenanigans that drove prices to ever higher levels, despite the absence of any supporting income growth to service the debt. The extension of credit to increasingly less financially worthy borrowers (a.k.a. subprime loans) can be traced to Wall Street's demand for mortgages that it could purchase, then dump in their securitization blender, sprinkle a little rating agency fairy dust on, and sell to the unsuspecting public as a AAA-rated bond investment. With the real estate market still on the ropes, and the only purchaser of mortgages for the last fifteen months being the Fed, it's easy to see that the need for mortgage brokers, investment bankers and the various trades-people involved in the real estate construction business (just to name a few related industries) has greatly diminished as the contraction in real estate has dampened the availability of, and demand for, mortgages. Anecdotal support for this could be found in the recently released March jobs report: despite the incremental improvement (thanks in large part to the hiring of census takers) in new jobs, which were much heralded in the media, the financial services industry shed *another* 21,000 employees.

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So where are we with housing at this point?

> *"Despite all the talk and even sporadic hard evidence of improvement in the economy, housing remains mired in misery, a lamentable fact that apparently hasn't sunk in to investors, to judge by the 25% rise in the home-builder group. New-home sales in February fell to an annual rate of 308,000, an all-time low. The number of mortgages at least 90 days past due shot up by 270,000, or by more than 20%. And operating on the theory that if at first, second or third times, you don't succeed, try, try again, Uncle Sam is launching still another program to forestall foreclosures."* *A. Abelson, Barron's 03/29/10*

Given the Fed's exit from the mortgage market at the end of Q1, and the prospect for rising rates in the future, we're struggling to find the white knight that can rescue the housing market, and suspect that it's going to be a long process to work off the excess inventory such that real estate related industries can be considered as contributing to overall employment.

But it's not just real estate related leverage that's going through this recalibration – it can also be seen across the financial services landscape from hedge funds to investment banking and trading. This reduction in debt, which was previously used to magnify returns (although "cripple" would seem more appropriate in hindsight), means there's a reduced overall "volume" in the financial services arena. As leverage is employed in a more prudent fashion, and not merely to finance an unsustainable trading bonanza, this reduced industry scale results in the need for fewer people – a trend that continued in the aforementioned March jobs report.

Combine a struggling housing market and a weak employment environment against the backdrop of the gyrations in the capital markets of the last 3 years, and you have a recipe for a somewhat reluctant consumer. The February report showed personal income continuing to flat line and consumer spending inching ahead, but wallets are only being opened in response to deals and incentives, such as cash-for-clunkers and the housing tax credit. And although an increasing savings rate is ultimately good for our country, it's a near term drag on the economy given that personal consumption (or the lack thereof) is still 2/3 of our GDP.

So the cycle-du-jour might see the consumer reducing debt and rebuilding their balance sheets (by adding to savings), which constrains economic activity via the lack of spending, thereby preventing employers from hiring until they sense a more sustainable pick up in demand, which therefore keeps the unemployment rate stubbornly higher than desired. And that just might be a dynamic that would continue to keep Joe and Jane Main Street in fiscal bunker mode a tad longer.

And let's not forget that overall employment has a massive hole to climb out of – 28 months after the start of the so-called Great Recession, we've lost 8.4 million jobs. Compounding that, just to stay even with the growing domestic population, we need to add 125,000 new jobs monthly – something we haven't done in quite some time, even in light of the March data.

"And we'll forgo quibbling that the 162,000 includes 48,000 census workers and 81,000 from the BLS's invariably generous birth/death computation. There's always noise in even the sweetest economic compositions, especially those that emanate from the talented fiddlers in Washington.

"But at the risk of being called a chronic spoilsport or something a bit more earthy, we should note that the report wasn't all milk and honey. For one thing, the unemployment rate stubbornly refused to budge, holding at 9.7%, and that means 15 million folks are still on the dole. Moreover, the best measure of the strength or weakness of the jobs market, U-6, which includes the underemployed, inched up to 16.9%, and folks out of work for what seems like forever but is actually 27 weeks or longer shot up to a peak 44.1%." *A. Abelson, Barron's 4/5/10*

Another aspect of this massive reset is going to center on the velocity of money, something which is directly linked to economic activity, as central banks around the world start sopping up the excess liquidity they deployed via a variety of stimulus initiatives designed pull us back from the precipice. This somewhat arcane topic focuses on the average frequency with which a unit of money is being spent. Assuming a static money supply, the more a dollar gets spent (increased velocity) the more active the economy is. As we've come out of this recession we see a significant increase in the money supply, but a sharp downturn in velocity, as banks haven't been lending and consumers haven't been spending. Although we don't know when banks and consumers may change their habits, we do know that it's inevitable the central banks will begin to reduce the overall money supply, which could *decrease* the velocity of money just when we're trying to move the economy forward.

"And now we are watching the Great Unwind of financial innovations, as they were pursued to excess and caused a credit crisis. In principle, a CDO or subprime asset-backed security should be a good thing. And in the beginning they were. But then standards got loose, greed kicked in, and Wall Street began to game the system. End of game.

"The financial innovation that drove velocity to new highs is no longer part of the equation. Its absence is slowing things down. If the money supply hadn't risen significantly to offset that slowdown in velocity, the economy would have been in a much deeper recession, if not a depression. While the Fed does not have control over M2, when they lower interest rates it is supposed to make us want to take on more risk, borrow money, and boost the economy. So they have an indirect influence.

"And now we come to the policy conundrum for the Fed. They have pumped a great deal of money (liquidity) into the economy. Normally, banks would take that money and multiply it by lending it out (through fractional reserve banking at a potential 9-times factor), increasing velocity and the overall money supply. In the past, the more the Fed increased the money supply, the more banks lent.

"But today bank lending is still falling at an average of 15% annually, so far this year." *J. Mauldin, Thoughts From the Frontline, 3/13/10*

As noted in this space previously, we do believe that there is a gradual recovery underway, although its pace will be understated as a result of the various issues outlined above. This financial restructuring, along with a renewed regulatory zeal, will temper the tenor of economic activity as the excesses are worked off over time. There will be opportunities, although perhaps as suggested by last year's bounce back rally, which may put the popular indices a bit ahead of economic reality.

> *"Valuation might as well be religion, for how many devotional sects exist. The Wall Street standard of looking at a forward multiple on current-year forecast S&P operating earnings of $77 produces a middling P/E of 15 -- a good deal below, incidentally, where it stood at the same point in 2004. And for those who scoff at the probability of profits gaining 25% from '09 levels to reach that $77, David Bianco of Bank of America Merrill Lynch calculates that the current members of the S&P 500 earned $85 both in 2006 and 2007.*
>
> *"Laszlo Birinyi of Birinyi Associates, who has been and remains unapologetically bullish with a 1325 S&P target, notes this would translate to a multiple of 17 on the 2010 consensus, which he calls "neither cheap nor extraordinary."*
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> *"More conservative measures-such as the P/E on average annual earnings of the past decade and the P/E on the median S&P stock, kept by Ned Davis Research-make the market look worrisomely more expensive, which should retard multi-year returns.*
>
> *"Put it all in a blender and it still seems the market is ripe for some give-back or time-marking action, yet nothing that would likely cost the bulls the benefit of the doubt over the longer term. Kind of like 2004."* *M. Santoli, Barron's 4/5/10*

In this new "look both ways before you cross the street" world, sticking to the basics of compounding income production within a diversified investment plan will still likely be a good game plan. And to reiterate what we said at the end of last year, we think the advent of a new decade should also be the tripping point to re-evaluate the assumptions and expectations you have within your overall investment and financial plan to make sure that what you're doing is going to get you where you want to go.

EQUITY MARKET OVERVIEW — INVESTMENT POLICY COMMITTEE

Gathering Headwinds…

The domestic equity markets celebrated the one year anniversary from the 2009 lows with another quarter of gains as stocks benefited from continued low interest rates, the expectation that the recession was over and the belief that the recovery was underway. When contrasted to where we were numerically, and emotionally, on March 9th of 2009, the changes in tone and tenor are striking. Gone is the certainty that a global meltdown and financial Armageddon are upon us, replaced instead with eerie complacency. The VIX, a measure of market volatility, whose pulse was taken almost hourly by the frenzied media in the midst of the crisis, quietly slipped unnoticed below 20 at the end of 2009. It had spiked to near 90 in Q4 2008 and stayed north of 50 in the dark days of the first quarter of 2009.

As we posited last quarter, the record ascent during the second half of last year was followed by continued, although a tad more muted, advances as we started 2010. The Dow Jones Industrial Average added a gain of 4.1% for the first quarter, while the broader S&P 500 added 4.9%, and the NASDAQ continued its run, climbing another 5.7%, albeit still off 53% from its tech-bubble peak at the start of the millennium.

In contrast to the last year, and consistent with the concept that nothing "goes up" forever, emerging markets took a powder this quarter as they digested last year's run, while the developed world's markets moved in a much more location/situation specific fashion. London's FTSE 100 added 4.9% in the quarter, Frankfurt's DAX gained a more restrained 3.3%, while the Paris CAC 40 could only muster a 1% increase. Tokyo's Nikkei benefited from a weakening yen and the perception that valuations may finally have become relatively attractive and marched ahead 5.2% to start the new year. Conversely, the PIIGS held fairly true to their unfortunate moniker, with their markets reflecting the concern about their fiscal condition. Portugal was off 4.2%, Italy declined 1.3%, Ireland, the lone "bright" spot, was up 1.3%, but Greece dropped 9% and Spain slipped 10%.

Similarly, the developing world performed in a less consistent fashion than the lock step march off the lows of last year. Each bourse reflected their sovereign fiscal and economic realities, along with likely some prudent consolidation from the 2009 appreciation streak. Using the BRIC-barometer for the emerging markets, Brazil's Bovespa was off 1.3% after last year's 82.7% run, Russia's RTS pushed ahead 5.7%, off the 2009 run of 128.6%, India's Bombay Sensex barely stayed positive adding 0.4% (having been up 81% the previous year), and China's Shanghai Composite responded to credit tightening in the Sino banking system by dropping 5.1%, giving back a portion of 2009's 80% return.

Despite this, the macro growth story over the longer term for the emerging markets is still intact as a number of factors point to more robust developing economies in the future. With 80% of the globes population domiciled in emerging markets, their comparatively youthful populations (median age under 35 according to the CIA) will be significant consumers for many years. Additionally, as export-centric countries, they went in to the recession with fiscal surpluses and reserves which have been of great value for investing in infrastructure to improve and stimulate their economies. Consolidating the gains of the last year is to be expected, and will provide additional allocation opportunities for patient investors – a perspective that is worth of consideration here at home as well.

As such, we remain "all-in" at this point with our sign-off from last quarter:

> *"We're just concerned about the staying power of all this activity once the excess liquidity starts to be reined back in, as it inevitably must at some point. The economy may chug along at lower GDP rates with higher unemployment levels for quite some time, and that appears to be out of sync with a market rebound that has pushed numerous valuation measurements to at least their long term averages. It would therefore appear that the equity indices have priced in a pretty rosy view of what the next year is going to look like from a profitability standpoint – and that's an assumption we feel may have some considerable air underneath it. Not that we don't believe there are opportunities, because there are. We just believe that the focus needs to be on income producing total return sectors that have lagged the indices and can provide the more sustainable returns that we think will be the norm going forward."*

Income producing sectors that lagged last year's run up, such as consumer staples, telecom, and utilities, to name but a few, continue to offer attractive valuations and compelling cash flow opportunities.

Still Treading Water…

With rates still firmly nailed to the floor, credit market developments in the first quarter of our new decade focused domestically on the Fed's transition out of the mortgage backed securities market, while overseas the drama was PIIGS related, centering on concerns about potential sovereign bond defaults. Although the end of Q1 2010 was "swine" centric (**P**ortugal, **I**taly, **I**reland, **G**reece, **S**pain) with regards to debt fears, foreign markets also had to wrestle with the continuing dynamic of Dubai going hat in hand to neighbor Abu Dhabi for the funds to pay off maturing sukuks, or Islamic bonds. Despite these developments, global credit markets ended the quarter pretty much where they started, thanks in large part to central bank intervention either from a monetary or quantitative easing standpoint.

Stateside all eyes (and trader's wallets) were on the Fed's continually telegraphed exit from the MBS arena after 15 months of standing in for the private investors that headed for the hills after the federal takeover of Fannie and Freddie. This government intervention was designed to prop up the domestic economy by mitigating the death spiral in residential real estate that came after the bubble burst.

> *"The program was initially for $500 billion. The purchases began in January 2009, and in March, the Fed raised the goal to $1.25 trillion. The purchases were to end by December 31, but in September, the Fed said the purchases would taper off more slowly, ending on March 31[2010].*
>
> *"The purchases caused rates for 30 year mortgages, which exceeded 6 percent in late 2008, to fall below 5 percent by March 2009. They are hovering slightly above 5 percent today" S. Chan, New York Times 4/1/2010*

And although thus far it has appeared to achieve its short term goal of stabilizing the credit market and reducing the spread between spread between 30 year mortgages and the 10 year Treasury note, stopping it hasn't been without concerns.

> *"The end of the program still leaves many uncertainties. The purchases have made the Federal Reserve the world's largest single holder of mortgages, a problem for the federal balance sheet if many of those mortgages go sour. It has also ballooned the Federal Reserve's balance sheet to $2.3 trillion, up from $700 billion before the crisis."*
>
> *N. Popper, L.A. Times 4/1/2010*

Eventually this paper will need to be sold off and the issue will be how that will impact rates in the face of unprecedented Treasury issuance.

> *"Treasury security issuance totaled $601 billion in the first quarter of 2010, compared with $454 billion in the first quarter of 2009, according to Barclays.*
>
> *"Investors eagerly acquired most Treasury offerings—until last week, when three large note sales met with lackluster demand. That helped push up Treasury yields, which move inversely to prices. The 10-year Treasury yield stood at 3.837% at the end of the quarter, compared with 3.834% at the end of 2009. It dipped as low as 3.546% in early February.*

"The potential for interest rates to rise significantly is perhaps the biggest worry for holders of corporate bonds, because rising rates hurt the value of existing bonds."
M. Aneiro, WSJ 4/1/10

With the F.O.M.C. keeping short term rates under its thumb, investors continued last year's run out the risk and maturity spectrum in an attempt to capture yield. Bond mutual funds continued to attract inflows at a far greater pace than their equity based brethren – leading to a potentially bubble like asset class build up in the face of rising interest rates. Yield-starved investment dollars absorbed a record $67.9 billion in junk bond new issuance during the quarter, as well as $225 billion of investment grade debt, to go along with the aforementioned Treasury issuance.

So if you combine a current interest rate environment that is artificially suppressed, significant supply that will be coming to market, along with post-recession concerns about sovereign debt-to-GDP ratios, it doesn't seem out of the question that we will eventually experience a rising interest rate environment in the future. The near 30 year bull market in bonds will likely hit an inflection point and credit market strategies will need to morph to address this reality.

As noted last quarter, our investment discipline still sees long term value in the fixed income foundation that prudent portfolios should be built upon. Given that the compounding of cash flow is such a significant factor in generating consistent long term rates of return, we continue to see this asset class as being both strategic and tactical. We will strive to keep our maturities in the short to intermediate range, maintain a laddered structure to spread our interest rate risk, and plan to add to our inflation protected and floating rate allocations both domestically and abroad as hedges against rising rates and currency fluctuations.

WEALTH MANAGEMENT UPDATE

529 College Savings Plans vs. Roth IRAs TRACY W. ROGERS & TRAVIS SPENCER

With the 2008/2009 market collapse many investors had to prioritize whether to save for retirement or their children's education. This has led to a slight decline in the use of 529 plans. Some of this pullback can be attributed in part to a broader retreat from the stock market as a whole. But another part can be attributed to parents who have opted to trade the tax benefits of 529 plans for college savings vehicles that don't have a "must-be-used-for-college" restriction. And as parents seek to save for their own retirement too, one such vehicle is a Roth IRA. This is a strategy that we have employed with various clients over the years. We will discuss how these two investment strategies compare as an education-funding vehicle.

Tax benefits
Both 529 college savings plans and Roth IRAs offer federal tax-free earnings if certain conditions are met (and most states follow this tax treatment), but only 529 plans offer the possibility of a state tax deduction too. For 529 plans, earnings are tax free at the federal level if the distribution is used to pay the beneficiary's qualified education expenses—a broad term that includes tuition, fees, room and board, books, and computers--at any accredited

college in the United States or abroad. If the distribution is used for any other purpose, earnings are subject to income tax and a 10% federal penalty tax. For Roth IRAs, earnings are tax free at the federal level if the distribution is "qualified." A distribution is qualified if a five-year holding period requirement is met and one of the following conditions is met: 1) you are at least age 59½; or 2) the distribution is made due to a qualifying disability; to pay certain first-time homebuyer expenses; or by your beneficiary after your death.

If you are younger than age 59½ and you have a taxable distribution, you will also pay a premature distribution tax (also called an early withdrawal penalty) equal to 10% of the earnings portion of the distribution. But there are exceptions to this penalty, and one is if the money withdrawn is used to pay your child's qualified higher education expenses.

Bottom line

If you withdraw money before age 59½ to pay your child's college expenses, you'll generally owe income tax on the earnings, but not an early withdrawal penalty. However, you may not end up owing income tax on the earnings, because Roth IRA distributions generally aren't taxed as earnings until the principal has been fully withdrawn.

Financial aid

There is an important difference here. Under federal financial aid rules, 529 plans are counted as a parent asset (if the parent is the account owner), and 5.6% of all parent assets are deemed available for college costs. By contrast, the federal aid methodology doesn't count retirement assets in determining aid eligibility. So a Roth IRA won't impact the amount of federal aid your child may be eligible for. However, although Uncle Sam doesn't count retirement assets, colleges typically do when awarding their own institutional aid.

Investment choices

Roth IRAs have the edge here--you can choose from a wide range of investments to fund your Roth IRA, and you can buy and sell investments whenever you like. But with a 529 plan, you are limited to the investment options offered by the plan. If you're unhappy with the investment performance of the options you've chosen, most plans let you change the investment options for your future contributions at any time, but for existing contributions, you can only change investment options once per year (twice per year in 2009 only). In 2008 and 2009, this restriction proved costly for many 529 account owners: having reached their limit on investment changes for the year, they were unable to make further changes in response to deteriorating market conditions.

Lump-sum contributions and eligibility

If you have a lump sum to contribute, 529 plans allow individuals to gift up to $65,000 in 2010 ($130,000 for married couples) and avoid gift tax if certain conditions are met. By contrast, Roth IRAs have a contribution limit in 2010 of $5,000 ($6,000 for individuals age 50 or older). And your ability to contribute to a Roth IRA depends on your income level. But anyone can contribute to a 529 plan--there are no restrictions based on income.

Bottom line

Both of these strategies have their merits. Whether a Roth IRA or a 529 college savings plan is best for your college savings depends on your personal circumstances and the factors discussed here. If you would like to discuss in more detail how this may fit into your overall plan, please schedule a consultation to discuss your personal situation in more detail.

Note on 529 plans
Given the myriad of states that sponsor 529 plans, an overall evaluation of the plan's investments, expenses and state tax treatments should be analyzed before investing. IMCG reviews the above factors on an ongoing basis to determine which of the states' plans best suits our clients' needs.

INSIDE THE MARKETS — FRANCIS J. DAVIES III

Fiduciary Standard

A sure way to lose friends is to mention that you favor increased government regulation – on anything, anywhere. "I am from the government and I am here to help" is a line that gets well-deserved laughs. It does not help matters when the new oversight is proposed by a Senator who has recently proven himself to be less than completely trustworthy. With all of that in mind, the reforms that Senator Dodd, chairman of the Senate Banking Committee, proposed for the financial industry in November deserved a better fate than the quick death brought by the enormous effort of the insurers, banks and brokers to kill it.

The financial industry exists for one purpose – to make money. When they spend a lot of money and lobby long and hard to kill regulations, it is for one reason - to maintain profits. Which is fine in a capitalist, free market. Unless you are one of their customers. Some of those lined up against Dodd were the American Bankers Association (ABA), National Association of Insurance and Financial Advisors (NAIFA), investment banks, hedge funds, student loan firms and credit card companies. The industry has been said to have spent $1 million per member of Congress on lobbyists.

The discussion draft of the bill released in November eliminated the broker-dealer exemption contained in the Investment Advisers Act of 1940, something that would impact stock brokers. Known as the "Merrill Lynch Exemption," it allows broker-dealers and their salespeople to offer "solely incidental" advice to investors without having to register with the SEC as an investment adviser. The repeal of the exemption would require all firms and financial advisors who wish to provide advice to clients to become Registered Investment Advisers (RIA). And that would make them subject to the same rules that we follow at IMCG. Much has been written about the difference between fiduciaries and sales people. Brokers, whether they are selling annuities, mutual funds, 401(k)s or insurance are held to the suitability standard. RIAs (like IMCG) are held to the fiduciary standard. There is an obvious difference between *suitability* and *fiduciary*.

Say you woke up today from a 10 year nap and walked into a Toyota dealership to buy a car. Do you think the salesperson is obligated to tell you about the stories of unintended acceleration? The cars are perfectly *suitable* – but do you deserve to know everything that the salesperson knows? If he is getting an extra 25% to sell cars that have been returned, would you like to know that? Now replace car purchase with investing your life's savings. Should the person handling that task be held to a higher standard than the person selling you a car? Why would anyone oppose the idea?

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The brokerage industry argued that there was no need for Senator Dodd to force their salespeople to be held to the fiduciary standard in his proposed financial industry regulations; they felt they were already acting as impartial investment advisors. The current TV commercials from UBS show a broker in his expansive office sitting down and talking to the client like they are old friends – a trusted companion. Since they *say* they are already acting like fiduciaries, why would the brokerage firms spend huge amount of time and money to eliminate the fiduciary standard? Because upholding the fiduciary standard would cost them money – money that would stay in the pockets of their clients rather than going into their revenues. In an ironic twist we learned this directly from the industry itself.

Guy Moszkowski is a research analyst for Bank of America/Merrill Lynch/Your Name Here who covers the brokerage industry. He wrote a report about the effect that enforcement of the fiduciary standard would have on Morgan Stanley/Smith Barney/All Aboard - one of the few big firms left standing after all the industry mergers necessitated by the mortgage meltdown. In Mr. Moszkowski's opinion, holding salesmen to fiduciary standards would have cost Morgan Stanley 7% of profits or $300 million a year. His explanation was, "Financial advisers will be expected to take into account not just whether a product or investment is suitable for the client, but whether it is priced favorably relative to available alternatives". Mr. Moszkowski is not saying that MS would be doing less business acting as fiduciaries, just that their profit margins would be cut by the $300 million that they are currently overcharging their clients.

The most effective disinfectant is sunlight. Full disclosure of costs and motivations would help customers by eliminating the ability to hide costs in packaged products, many of which exist only because of the high commissions they pay. Currently, firms do not make it simple to learn this crucial information. If an investment is so complicated that it cannot be explained, that is a warning. This is especially true in manufactured products – like wrap accounts, annuities or whole life. Often, the name of the product on the shiny brochure often has very little to do with what the broker is actually selling. A couple examples:

<u>"Preferred" mutual funds</u>. Many broker firms maintain a list of these funds and they strongly suggest clients choose one of them. A fund becomes "Preferred" not due to stellar performance or low cost. They get on the list by agreeing to kickback part of their fees to the brokerage firm, which then shares that with the broker. The fund could be decent but the difference between the "preferred" fund and one of the top funds in that sector can be costly to the client. And the client's loss is the brokerage firm's gain. With full disclosure, at the bottom of the list would be a footnote explaining that the funds listed above paid for their preferred status and would caution that other better performing, less expensive funds might be available. It would read like the warning on a pack of cigarettes.

<u>"Target Date Fund"</u>. A recent Wall Street invention, these were sold as "set it and forget it" investments. You buy one of these funds targeted to the year you want to retire and it automatically moves your assets from equities to bonds as you approach retirement age. There are a couple real life problems with this nifty concept. The asset allocations vary wildly from fund to fund. As of 2009, Wells Fargo Advantage 2010 had 25% of its holdings

in equities, Fidelity Freedom 2010 was 49.1% in equities and T. Rowe 2010 had 57% of its monies in stocks. The costs also vary. Vanguard charges 0.19% for their target funds while the fees for the Oppenheimer Transitions target fund total 1.44%. Not surprisingly, results also vary greatly. When the market collapsed in 2008, the 2010 target funds averaged a 25% loss. The worst performer was Oppenheimer Transitions which lost 41%, proving once again that lowering costs is one of the best ways to improve returns.

Principal Protected Note. One of the most dangerous products to come from Wall Street in recent years was this structured loan product. These were marketed as Treasury alternatives for people needing income, like retirees and others who could not afford loss of principal. The notes were sold as a risk-free way for an investor to participate in the growth of the stock market with return of principal guaranteed by the borrower. In actual fact, these were risky, unsecured promissory notes linked to a referred security. The reason these products exist was simple: brokers do not get paid anything for putting their clients in Treasuries. However, these notes paid a 3% commissions; a million dollar purchase meant $30,000 in gross commissions, an unheard of payday for a short-term loan. An article in the recent *Forbes* detailed how UBS sold a lot of these to their clients. Unfortunately for the investors, the borrower guaranteeing the return of principal was Lehman Brothers. When last seen, they were selling for 3 cents on the dollar.

UBS salespeople continued to push these Lehman Brothers "100 Percent Principal Protected Notes" even after the collapse of Bear Stearns. The state of New Hampshire brought action against UBS, charging that "UBS presented these notes as simple, safe investments when in fact they are highly volatile and are subject to shifting market conditions." Even more troubling is that while its American brokers were stuffing the Lehman notes into every account, UBS bankers in the UK were helping Lehman disguise its dire circumstances. UBS is said to have done $10 billion in Repo 105 deals with Lehman – these are the transactions that allowed Lehman to move liabilities off its balance sheet. For this, UBS collected tens of millions of dollars in interest payments.

There is no end to the horror stories. The complaint alleging fraud in connection with Merrill Lynch's sale of auction rate securities in Massachusetts contains language not suitable for young children. What should be the ultimate responsibility of the financial industry? Does their liability end at the moment of sale, or should they be held accountable for the long term? Pay based on advice may make more sense than sales charges. There is no escaping the difference between compensation based on the value of advice delivered over the long term and immediate sales commissions. There is no justification for hiding sales charges. Thanks to the lobbying power of the financial industry, the SEC will now study these topics yet again for another 18 months. Any hopes for reform now rest on Paul Volcker.

RETIREMENT & FIDUCIARY CONSULTING UPDATE — STEPHEN L. EDDY

"All In Fees"

If you remember last quarter's article on mutual fund fees, you will recall that they are all at once some of the most opaque, creative, cumulatively penalizing and confusing fees around.

They are one (albeit major) component of the focus of this quarter's topic: the "all-in" fee, aka, "what is your retirement plan really costing you?" (Am I the only one who finds it strangely amusing that the retirement plan industry has adopted a do-or-die poker term as a tool to help describe their fee structure? I have a great long-winded analogy here, but it will have to wait for next quarter).

Before we look at the tremendous variation in "all-in" plan costs, let's first review the basic categories in which you, as a plan sponsor or plan participant, are being charged. Add these categories up and you arrive at the total "all-in" cost for your plan. Typically, fees are generated for typical 401k 0r 403b salary deferral retirement plans (defined here as under 500 participants and under $20 million in assets) from most of the following categories on an at least annual basis:

Fee Category	Charged By	What it Covers	Typical Annual Range	Paid From
Investment	Mutual Fund; Asset Manager	Costs related to asset management, custody, securities trading and operations	.10% to 1.50% of assets	From: Fund Balances
Marketing	Broker	Payment from platform to broker for selling a platform solution to a client. Commission-based, broker not a fiduciary, can create conflicts of interest	.25% to 1.50% of assets, plus up to 5.75% sales load on contributions, plus up to 1% of assets transferred up-front commission	From: Fund Balances
Accounting	Accountant	Plan audit for plans with over 100 participants	Hourly or by project, depending on complexity	From: Sponsor
Legal	ERISA Attorney	Documentation and problem resolution	Hourly or by project, depending on complexity	From: Sponsor
Recordkeeping	Third Party Administrator (TPA); Platform	Processing of online or paper statements, plan reports, plan testing, plan design, documentation, distributions and contributions	$1800 - $10,000 for typical plan	From: Sponsor or Fund Balances
Fiduciary	Registered Investment Advisor; Independent Plan Fiduciary; Plan Trustee	"In the client's best interest" unbiased consulting advice regarding platform and fund selection, fund monitoring, compliance and participant education and advice	.10% to .60% of assets depending on scope of service, often expressed as a flat fee	From: Sponsor or ERISA account

As you can see, accounting and legal fees are almost always paid by the plan sponsor, and not the plan. Recordkeeping and fiduciary expenses are often paid by the plan sponsor, (but can come out of plan assets set aside specifically for plan expenses). That leaves two basic expenses that plan participants regularly pay – investment expenses and marketing expenses. And these are the two primary components that can drive "all-in" plan expenses from under 1% of assets to upwards of 3% of assets. It all comes down to who is getting paid and why.

I feel that I need to again stress how important this is: just a half a percent difference in your fees significantly impacts balances over time (you know, the whole idea behind 401k and 403b savings plans – SAVINGS OVER TIME) and can amount to tens of thousands of dollars in your account balance. This is important stuff.

Here are the factors that create significant differences in investment and marketing expenses:

SHARE CLASS OF INVESTMENTS

- Institutional share classes (I shares) have very little in the way of sub-TA fees and no 12b-1 fees. They are the least expensive of the share classes, since they usually only charge you for management and fund administration.
- Other share classes (usually denoted by a letter/number such as A, B, C, R1, R2, R3, etc.) have up to an additional 1% of assets deducted in the form of 12b-1 fees.

ACTIVE MANAGEMENT VERSUS INDEXED

- An index fund is comparatively inexpensive, since it is traded automatically by a computer, based on the market index to which it is tied (the S&P 500 for example). The drawback is your assets will grow or shrink at the rate of the market, less any fees.
- If you want to try to outperform the market, you would choose an actively managed fund. The management fee is up to 1.5% of assets in some cases, so your outperformance better reflect at least that in return.

MUTUAL FUND PLATFORM VERSUS INSURANCE PLATFORM

- Insurance company platforms (John Hancock, Great West, Principal, MetLife, etc.), often utilize group annuity contracts for their retirement plan products. Think of a group annuity contract as a plan “shell” that generates additional fees. In addition to 12b-1 fees in the underlying funds that make up the group contract, there is usually a charge that is a basis point fee add-on that goes toward paying the broker or insurance agent that sold the plan. This can cost up to an additional 2% of assets.
- Open architecture mutual fund-based platforms are almost universally less expensive than insurance company platforms, until you get into the 1% range of 12b-1 fees with different share classes. However, they can sometimes be too limiting in available investment options and platform support for participant education.

Since the “all-in” fee can range anywhere from .35% ($10 million plus plan, index funds and ETF’s) to 3% (less than $5 million plan, group annuity contract, outside recordkeeper), anyone who is participating in a plan or whose company is sponsoring a plan should know the answers to the following questions:

- Who gets paid from the funds?
- How much do they get paid from the funds?
- What do you get for the fee you pay?

The trick is in knowing where to look for the answers, and who to ask. These questions will get easier to ask as we move forward with the forthcoming fee disclosure regulations.

Next quarter: Mailbag! I answer reader questions.

IMCG NEWS

FRED WILLIAMS – While meeting with clients on the east coast, Mr. Williams attended the Morningstar Ibbotson Conference in Orlando in early March. This analyst's symposium continues Ibbotson's tradition of bringing academic theory to industry practice, with thought leadership on asset allocation, investment research, economic analysis and portfolio strategy. This year's gathering featured keynote presentations by founders Roger Ibbotson and Larry Siegel, amongst others.

Additionally during the quarter he traveled to Louisville for The Dream Factory's Annual Board Meeting. Having served with the local chapter for 15 years, Fred is also on the national organization's Executive Committee and chairs their Finance Committee.

STEVE EDDY – Was recently elected to the Board of the Maine Employee Benefits Council, where he currently is serving a term as Treasurer. Steve is in the midst of coaching the Scarborough High School girl's tennis team, while also starting his first season coaching the USM Men's Tennis Team.

FRANCIS J. "TERRY" DAVIES III - Has recently completed the level three 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.

ELIZABETH DEELEY-GALLUP - We are pleased to announce that Liz has joined our *Client Development & Support Group.* She comes to us with previous experience in the retirement plan industry, including client support within financial service organizations. Liz lives in Falmouth with her four children and the firm looks forward to adding her talents and perspective to the team's efforts as a *Client Service Associate.*

SAVE THE DATES:

We're entering the time of year when a variety of non-profit organizations begin their fundraising efforts. In these challenging economic times financing the continuation of their programs and services requires even more effort from their dedicated volunteers. Although by no means complete, the events below are but a sampling of the organizations that our firm, employees, colleagues and clients are involved with:

> ***17th Annual Chef's Gala "…is off to the races!"*** – Dinner, by a variety of local chefs with a Kentucky Derby theme, and dancing to benefit Maine Coast Memorial Hospital's Breast Clinic. To be held May 15th, 5:30 P.M. to midnight, at the Maine

Coast Mall in Ellsworth, Maine. Additional information and tickets can be found at www.mcmhospital.org.

7th Annual Camp Ketcha Golf Tournament – To benefit the Camp's programming, youth development and community support services, this event is scheduled for June 15th at the Prout's Neck Country Club – registration begins at 10:00 AM. Additional information can be found at http://campketcha.com.

17th Annual Child's Play Golf Benefit – The Dream Factory of Maine's annual event to raise funds for its mission of granting dreams to the critically and chronically ill children of Maine. Scheduled for Friday June 4th at Sable Oaks and starting at noon, 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.dreamfactoryincmep.org.

9th Annual Sea Dog Invitational – To benefit The Opportunity Farm for Boys & Girls, this year's golf tournament will mark the organization's *Centennial Celebration* and be held at Sable Oaks Golf Club on Saturday, June 12th with registration starting at 8:00 AM. Additional information can be found at www.opportunityfarm.org.

Fore The Kids Golf Classic – Big Brothers Big Sisters of Southern Maine's annual fundraiser will be held June 28th at The Woodlands Club. Additional information on this popular two-ball/best-ball event can be found at www.SoMeBigs.org.

Greg Francoeur Memorial Golf Tournament – The 7th annual event to benefit the scholarship fund managed by the Maine Community Foundation which provides support to students enrolled at Carrabassett Valley Academy who would not be able to take advantage of educational and training opportunities without financial assistance. Contact Gary Francoeur at garyfrancoeur@comcast.net for more information about the event to be held Friday morning July 9th at the Val Halla Golf Course in Cumberland, Maine.