INVESTMENT MANAGEMENT & CONSULTING GROUP

VIEWPOINTS

2ND QUARTER 2010 ADVISORY NEWSLETTER

MARKET COMMENTARY FREDRIC W. WILLIAMS

The Great Unwind…

Like a well written script, the 2nd quarter of 2010 served up a variety of attention grabbing headlines as the trajectory from last year's moon shot rebound in the capital markets found itself facing a variety of issues after a year's worth of unimpeded levitation. From "The Greek Tragedy" to "The China Syndrome" and "Flash Crash", we didn't lack for catchy snippets in the media that attempted to label events circulating about the capital markets as investors tried to discern the direction and condition of the economy over the near term. Concern about the causes of, and potential contagion from, Greece's bailout, along with the fear that a slowdown in China could derail a nascent global recovery, became players in the drama that pulled fear back in to the markets as questions emerged about everything from jobs and housing to the impact that an increasing savings rate will have on domestic GDP. Additionally, the as yet not fully explained May 6th plunge in the Dow, nearly 1000 points in less than half an hour, was merely another factor stressing market participants who have been beginning to resemble the proverbial cat on a hot tin roof with their tendency to sell first and ask questions later.

Investor muscle memory continues to be fixated on 2008, which causes greed to be trumped by fear and may be resulting in opportunities for those whose perspective allows them to view both the forest *and* the trees.

> "*Cash is an option on tomorrow, that thing that we can't see but can only imagine. A dozen years ago, the future wore a smile. It was going to be even better than today, which was just about perfect. Now the future looks even scarier than the present, which is bad enough. Taxes are going up, the euro is disintegrating, China is teetering, Iran is acquiring nukes, unacknowledged billions of bad debts are festering, deflation is lurking (or maybe it's inflation) – you name it. One comes to imbibe the view that "risky" investment assets will be inevitably cheaper tomorrow than they are today.*"
>
> *Grant's Interest Rate Observer 6/11/2010*

All of the aforementioned Q2 mini-dramas are likely symptomatic of the macro trend of global deleveraging that will influence behavioral changes within consumption and finance, expectations for future economic growth based on these activities, and the resulting performance of the capital markets in what is becoming referred to as the "New Normal".

The unwinding of the debt super cycle that is emblematic of the last 50 years will see increased personal savings rates as individuals rebuild their balance sheets by paying down debt. The public sector will be forced to curtail spending and increase taxes as a means of balancing budgets and, more importantly, retiring previously incurred deficit debt. No matter how you slice it, there will be fewer dollars available in our economy for consumption, and potentially less of an inclination to spend as we gradually move through this recovery process.

> *"As troubling as June's statistics on consumer spending and confidence were for the prospect of renewed consumption, the reports pale in comparison to a new study by PricewaterhouseCoopers that forecasts a gradual rise in the savings rate over the next five years to a whopping 10%.*
>
> *"Despite rampant unemployment, the personal-savings rate, the share of after-tax income that isn't spent, rose to 4% in June. That is more than double the average rate in the year before the recession officially began in December 2007.*
>
> *"Some economists have predicted that the savings rate will hit 6%, but a 10% rate, which would resemble the 8% average in the '80s, would have profound implications for the consumer spending that constitutes 70% of economic activity…*
>
> *"The key trend that will lead the savings rate to double digits, the study says, will be increased uncertainty about retirement income, and the demographics that will push 76 million baby boomers into retirement over the next few years. Another factor? Less access to credit."* *Barron's 7/5/2010*

Although Greece has been the recent epitome of financial excess, much of the developed world, including the U.S., has similarly accepted "structures" that will need to be unwound as well. Whether it is the belief that everyone can own their own house, that life time jobs and pensions are inalienable rights, or that 30 hour work weeks and 3 months of paid vacations constitute a full time job, the social "contracts" between governments and their citizens will need to be rewritten in this era of deleveraging and fiscal austerity. As Neil Peart opined in Rush's similarly titled 1976 release from the album *2112*, "You don't get something for nothing" – which we believe will be a central theme as the great unwind moves forward.

Just as there's no doubt that increasing the government supported security nets in the developing world, where little exist, will spur consumption, it's equally clear that the other extreme in the developed world can no longer be effectively financed. Whether it's addressing Social Security and Medicare in the U.S., Couverture Maladie Universelle coverage in France, or raising the Greek retirement age from 60 to 62, the future will be about what these programs realistically cost rather than what's politically expedient around election cycles.

Combine this new found future fiscal reality with the present day boots on the ground issues we continue to face on the employment and housing fronts, and it's understandable why investors have pushed their tolerance dial away from perceived risk recently – and perhaps at the expense of their own longer term benefit.

> *"To some, Treasurys are endowed with safety because the federal government can materialize dollars, whereas stocks are endowed with risk because corporations can't. To*

others, a "safe" asset is an appreciating one. Treasurys appeal to this kind of investor because interest rates have been falling since 1981. And while we acknowledge that there's something to be said for certainty, and a lot to be said for bull markets, it's hard to beat a good asset that's been given up for lost. As for the government's well-exhibited capacity to conjure money, we can't think of a better reason not to own government securities. Hence our preference for…roughed up equities. Big, stable, dividend-paying, adaptive corporations can survive in most monetary and fiscal settings. There's nothing adaptive about a bond. It never even opens a newspaper." *Grant's Interest Rate Observer 6/11/2010*

As we discussed in the past, we've looked for a consolidation of the markets' 2009 and have retained cash to incrementally take advantage of opportunities as they present themselves. Regardless as to how one views the various policy decisions made to address the Great Recession and its after effects, longer term market participants should first determine what they need, and when, from the investment process – and then make systematic deployments accordingly. Trying to time the markets, in an attempt to identify the perfect exit and entry points, is an exercise in futility and increased risk. Albeit quaint, figuring out which road will get you to your destination is the best first step – and is one that should be reviewed regularly. The fuel to move you down that road is the cash flow derived from the allocation of ones assets, which may not necessarily be correlated with what the media's talking heads are buzzing about on any given day.

EQUITY MARKET OVERVIEW — INVESTMENT POLICY COMMITTEE

Speed Bump – Or The Dreaded Double-Dip?…

As we noted in our *"Gathering Headwinds"* commentary last quarter in this space, we arrived at the mid- point of 2010 with some of the luster of the last year's rally in the equity markets a bit more subdued that in previous quarters. After racing through the one year anniversary of the March 2009 lows, the equity markets ran out of steam early in the second quarter as concerns mounted that the economy may not have been recovering at the intensity that the stock market was implying. Four straight quarters of above average positive returns in the domestic equity markets came face to face with a variety of concerns from Europe to jobs and housing – and the indices blinked, declining over 10% from their April highs.

The recently somnambulant VIX, a measure of market volatility mentioned last quarter, bottomed around 15 (after printing near 90 in Q4 2008) before more than doubling to 34.54 as a cascade of not-so-good news buffeted the equity markets during this year's 2nd quarter.

The first quarter's gains were given back (and then some) as the Dow Jones Industrial Average declined 10% in the second quarter and hit the mid year mark off 6.3%, while the broader S&P 500 dropped 11.9% [down 7.6% year to date], and the NASDAQ slipped 12%, off 7% since the start of the year.

In addition to concerns about the domestic recovery, investors fretted about the impact that global developments could have on economic activity, and thereby corporate profits:

"As the quarter progressed, the situation in Greece deteriorated rapidly and worry about "contagion"—the idea that the crisis would spread far beyond its roots—reared its head and slammed stock and bond markets in other debt-laden European countries. At the same time, some investors grew worried that China, in an effort to slow its booming economy, would end up slamming on the brakes too hard and derail a key global growth engine.

"As if that wasn't enough, the May 6 "flash crash," when the Dow plunged 700 points in just eight minutes, raised concerns about the soundness of the day-to-day workings of the U.S. stock market.

"With investors facing a laundry list of macroeconomic woes, the response has been an exodus from riskier investments that rode the initial wave of optimism about a global recovery starting last March."

T. Lauricella, WSJ 7/1/2010

Overseas markets resembled the old real estate saw, as it was all about "location, location, location" with returns varied depending on country and region specific issues. London's FTSE 100 dropped 13.4% in the quarter, hitting mid year off 8.5%, Frankfurt's DAX declined a more subdued 3.1% and was actually up 0.2% for 2010, while the Paris CAC 40 slipped 13.4% down 12.4% year to date and Tokyo's Nikkei finished the quarter down 11% for 2010.

"It doesn't take a genius to figure out what was worrying stock investors during the second quarter. Just look at the laggards among global stock-market performance: Greece and China.

"China—an engine of growth coming out of the recession—has been tightening lending and land sales to combat a perceived property bubble and a broader asset-price frothiness. Greece has been the symbol for European fiscal woes.

"Amid the persistent concerns about property bubbles and inflation—and the possibility of tighter government action to stop them—the tumble in Chinese stocks steepened during the second quarter.

"Whether investors have overreacted to strained finances of some European countries remains an open question. Concern over the weak fiscal position of European nations such as Greece, Spain, Portugal, Italy, and Ireland ratcheted up in late April and early May. That resulted in credit-market upheaval, as the prices for sovereign debt of such nations plunged and yields spiked." *M. Phillips, WSJ 7/1/2010*

As expected Greece dropped another 30.6% in the quarter and China slipped 23%, both as a result of country specific concerns, while others like Chile (up 8%), Columbia (plus 2.5%) and India (adding 1%) were actually able to post market gains.

Not all of the talking heads are dour on the global state of affairs, as strategist Ed Yardeni, an old acquaintance from our E.F. Hutton days, was seen commenting on while recently traveling on business in Europe.

"According to Yardeni, things are looking up in the EU since the dark days that followed the Standard & Poor's downgrade of Greek sovereign debt to junk in late April. Last week, for instance, Germany's Ifo business-sentiment index in June edged up to its highest level since May 2008.

"What makes this result particularly noteworthy, says Yardeni, is the fact that a decline was widely expected, especially in the wake of Chancellor Angela Merkel's proposed budget cuts of 80 billion euros ($99.1 billion) over the next four years. So much for budget austerity quenching businesses' animal spirits.

"Other signs abound of a fundamental restructuring of the EU welfare-state model, which Yardeni insists will redound to the ultimate benefit of Europe. He cites labor reforms passed last week by Spain's lower house making it easier and cheaper for businesses to fire workers. Adoption of such legislation would boost rather than discourage hiring and help bring down Spain's soaring unemployment rate.

"Too, the new coalition government in the U.K. unveiled last week an "emergency" budget, designed through spending cuts and tax hikes to reduce the nation's structural deficit problem by some 8% of GDP in the future. The news is much the same throughout the EU—substantial deficit cuts and proposed major changes in employee-benefit regulations such as boosting retirement ages." J. Laing, Barron's 6/26/2010

In a similar vein stateside, the ten thousand foot view of the last decade provides some perspective that suggests valuations post this most recent correction are approaching attractive levels for patient longer term investors. After over-shooting historical averages during the dot-com rush of the 90's and then underperforming during the first decade of the new century, investors have become much more manic about their expectations for the capital markets – especially as they view the most recent events in their review mirror.

"But it does mean that something approaching the historical market returns of the pre-bubble period has become a decent bet again. The S&P 500 is down by a quarter since 2000, while its companies' profits have doubled and long-term interest rates have been halved.

"Near the recent market lows, the comprehensive Wilshire 5000 index was flirting with a trailing three-year annual total return of minus 10%. Since 1970, it has had a 10% or greater three-year annual loss three times: near the 1974 market low, at the 2002-2003 bottom and in early 2009. In the first two instances, the markets didn't quickly turn for the better as the trailing loss hit 10%. But both times, after first reaching a 10% three-year loss, the market produced a handsome annual return over the next three years—22% and 18%, respectively." M. Santoli, Barron's 6/14/2010

Given the abundance of negative sentiment surrounding the prospects for the economy and markets, as well as the continued flow of dollars into the retail fixed income mutual funds, we think opportunities in the income producing sectors that lagged last year's recovery rebound are compelling. As the ongoing deleveraging process continues, for both individuals and institutions, we see the resulting subdued growth environment favoring the total return mantra of current dividend cash flow and gradual future appreciation.

BOND MARKET OVERVIEW — INVESTMENT POLICY COMMITTEE

Fear and Loathing – In Europe…

After a near year long run, the credit markets retrenched during the 2nd quarter of 2010 as fear crept back into the trading pits in the form of sovereign debt worries in Europe spilled over into the domestic bond market and bank lending activities. The boogieman was still

PIIGS-like (**P**ortugal, **I**taly, **I**reland, **G**reece, **S**pain) as concerns mounted that some of the southern tier countries might lack the political will to implement the austerity measures that were required in the refinancing agreements hammered out with the IMF and ECB early in the quarter. The resulting flight to safety benefited Treasuries, and the dollar, at the expense of just about all other sectors of the credit and currency markets.

> *"Signs of credit-market stress were everywhere. The cost of protecting against the default of an investment-grade borrower in the credit-default-swaps market surged 39% in the quarter to its highest level since last summer, according to financial-data provider Markit.*
>
> *The three-month London interbank offered rate, at which banks lend money to one another on a short-term basis, rose to more than 0.5%, also the highest since last summer."*
>
> *M. Gongloff, WSJ 7/1/2010*

The uptick in bids for Treasuries pushed prices higher and yields lower across the maturity spectrum. The 2 year note started the quarter with a yield of 1.02% and ended June at 0.63%, while the 10 year went from 3.84% to 2.96%, and even the 30 year bond closed out the 2nd quarter with a yield below 4%.

> *"Last week's slide in U.S. rates couldn't (only) be attributed to a flight to the safety of Treasury securities. Indeed, the European debt situation calmed down a bit, at least temporarily, as Spain held a successful debt auction and European banks survived the quarter end without feared disruptions.*
>
> *"The government bond rally reflected the two major weak points of the American economy—employment and residential property. So much evidence of the debilitated state of these areas accumulated during the week that Friday's news of a much weaker-than-expected June employment report was an anticlimax. That proves technical analysts' dictum that the markets make the news rather than the other way around."*
>
> *R. Forsyth, Barron's 7/5/2010*

The flip side to this trade has been the exodus from any perceived risk allocation, with investment grade borrowers being thrown in the same lot with lesser credits and seeing new issuance dry up (down 42% in the quarter according to Dealogic) in the face of vacating demand. Credit spreads widened and LIBOR rose as traders had only Treasuries on their monitors and banks horded cash, rather than lent, as they pondered the various iterations of financial "reform" that were being bandied about on both sides of the pond.

In addition to the weekly economic data-du-jour releases that the markets have fixated on more intently of late, the F.O.M.C. meeting in late June attracted eyeballs as bystanders attempted to discern the Fed's perception of current affairs and any potential for changes in interest rates.

> *"The Federal Open Market Committee offered few surprises, with the statement coming out pretty much as expected, with little altering to the low --for-the-long-hall stance. The words stay, exceptionally low for "extended period of time," they acknowledged that the economy was stumbling and Kansas City Fed's Hoenig stayed on the dissent over the language, seeing it as somewhat painting the policy posse into a corner. Going on the*

information they had back in April suggested "that the economic recovery is proceeding and that the labor market is improving gradually."

B. Malloy, Briefing.com 6/25/2010

A more pedestrian description of the Fed meeting's release was offered by Bankrate.com:

> *"Since the last time the rate-setting committee met (in late April), the economy continues to recover and jobs are being created, gradually. Consumers are spending more, but are hampered by joblessness, stagnant wages, declining home values and stingy banks. Businesses are spending more on equipment and software, but not on buildings and new employees. Home construction is in the dumps. Banks are more reluctant to lend than they were a few weeks ago, mostly because of the financial crisis in the European Union. Nevertheless, the Fed thinks employment will continue to grow slowly and inflation will remain contained."*

The catalyst for this quarter's fear induced run was primarily Euro-centric, coupled with concern about the contention of the economy (domestic and global) post the stimulus injections of the last 18 months. Although Spain had successful debt auction at the end of the 2nd quarter, and European banks suffered no disruptions as the ECB's 12 month lending facility expired, it appears that a wary eye will continue to be cast on the Euro zone in an attempt to measure the success of the austerity programs being implemented across the continent.

With domestic interests having little room to decline, and an argument being made that the U.S.'s debt-to-GDP ratio is nothing to write home about, it seems likely that the longer term trend could be a weaker dollar and rising interest rates – something we think is prudent to prepare for, even in the face of shorter term deflationary fears.

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

Financial Aid Basics

TRAVIS SPENCER

A co-worker was once told by a financial aid officer that the perfect storm to maximize financial aid would be to max out your home equity, lose your job, and get a divorce. Since we are wealth managers we don't recommend this as a strategy. With the cost of college rising and endowments dropping, many folks are concerned with how they are going to pay for a secondary education.

This is part one of a two part series on things you need to know about financial aid and the filing process. Once your child gets accepted into college you begin the walk through the alphabet soup of forms and financial aid jargon. Hopefully our secret decoder ring can make it clearer.

FAFSA – Free Application for Financial Aid

The FAFSA collects data used based on a needs analysis formula created by the federal government. This formula determines eligibility for federal and state financial aid as well as institutional aid. The FAFSA is completed online, using the previous year's tax return and is a snap shot view of your financial assets. It is filed annually. On the FAFSA, you indicate the schools that should receive this information: multiple schools during the application process in the first year, and only the school you wind up attending after that.

EFC – Expected Family Contribution

This is the amount you will be expected to pay for college based on your particular financial circumstances. This number is determined each year by the federal government or the individual institution based on information you provided on the FAFSA. Generally your EFC is the same regardless of the cost of the school. For example, if your EFC is determined to be $5,000 for that year, a college that costs $8,000 would have an aid package for up to $3,000 and a college costing $25,000 would have an aid package for $20,000. In either situation your expected contribution would be the same amount.

Federal Pell Grant

The grant amount available is determined by information you put on the FAFSA. If you are eligible for grant aid, the amount you receive would be the same regardless of the school you attend. Grants don't need to be repaid.

CSS/Financial Profile

This is a financial aid application used to award non-federal student aid. Private institutions use this to help them determine financial need. This profile asks slightly different questions about your financial situation than the FAFSA does. Many private colleges have their own formulas and they use the CSS to help them make their final aid offer. Most schools expect you to complete the both FAFSA and the CSS.

Once you are accepted, the schools offer you an aid package based on all of the above. This package could consist of grants and scholarships (which don't need to be repaid), work-study aid which provides the student with part-time employment to help meet financial needs, and finally loans.

The main thing to remember is not to assume that you won't qualify for aid or that a school is too expensive. If you can afford the $75 application fee, apply to each school you are interested in attending. You may be surprised at the packages you receive. Many private schools have greater access to funds for financial aid than you realize, and many accept on a "needs blind" basis, which means they don't hold you or your family's ability to pay against you during the application process. Be willing to talk to the financial aid offices; everyone has a unique situation and it is in your best financial interest to explain your situation to the school to see if you can get a better package.

Next quarter we will discuss the dos and don'ts when it comes to financial planning for maximizing college aid.

No-Loan College Education TRACY W. ROGERS

Editor's note: Before you read on (if you've made it this far), please refer to the first installment of Travis Spencer's two-part ***Financial Aid Basics*** *article, also in this newsletter, for definitions for some of the terminology that is about to be thrown around in this article. Travis does a nice job explaining the various government forms, esoteric terms and different methods of funding used in the college application/financial aid world.*

Recently, I was approached by a company that helps teach Advisors how to present "college funding" seminars. Their hook: take your hard-earned savings earmarked for college and purchase a life insurance policy to "hide" assets from the colleges, which in turn means you will qualify for more financial aid. In effect, the pitch was to help them drive up life insurance sales through a tax loophole, probably not the smartest way to use your money. However, the concept of qualifying for more financial aid appeals to everyone who has ever seen a college tuition bill. Wouldn't it be nice to pay the same price to attend Harvard as it would be to attend a state school? Wouldn't it be nice to have your child graduate from college without any debt or at least with limited debt? That world *does* exist, and not only for low-income families.

That No-Loan College Education world began recently, and it started with low-income families (low-income being defined as up to 200% of the poverty level - for a family of four in 2010, 200% of the poverty level was $44,100). In the past decade, around 70 U.S. schools instituted policies that tried to ensure that students from low-income families had no debt when they graduated. In 1998, Princeton was the first to offer this type of program.

Princeton expanded the no-loan concept to cover all students in 2001-02 and other colleges followed suit. Much of this newfound generosity from the colleges (i.e. Princeton's "cover all students") came in the wake of wildly escalating college tuitions that generated some not-so-veiled threats from Congress. Essentially, some Senators took offense that private schools (whose tuition rate increases had drastically exceeded cost of living increases) had endowments with billions of dollars in them that were growing on a tax-exempt basis, without being spent on the students. In essence, Congress threatened, "use the endowments to reduce the cost of education or we will tax them".

Now, many schools offer no-loan or limited loan policies. Many accept students on a "needs blind" basis. That means that if you are a qualified student, you are accepted on academic or athletic merit, not on your family's ability to pay. The schools only use the FAFSA or CSS form information after you have been accepted. Then the financial aid fun begins. If you are fortunate enough to be accepted at more than one of these institutions, you will be able to compare financial aid packages before you make a decision.

There are four sources of funds to pay for college tuition: the student (their own money, borrowed money, gift/trust or scholarship), the parents (their own money or borrowed), the federal government (grant), and the school itself (grant/award, work-study). This is where the money to pay tuition originates – nowhere else.

Each school approaches tuition financing a little bit differently. There are four basic categories for no-loan/limited loan policies. They are:

- **No loans.** These policies eliminate loans from the financial aid package of low- income students. In Princeton's case, the loans are eliminated from the aid packages of all students, not just low-income students. Other schools with no loan policies for low-income students include Rice University, UNC Chapel Hill, University of Virginia, and the University of Pennsylvania.
- **Loan caps.** These policies institute a low cap on student loans for low-income students. Examples of schools with such policies include Brown University.
- **No parental contribution.** These policies eliminate the parental contribution, but retain the student contribution along with the standard self-help level. So these policies may still require some loans in the aid package, albeit a reduced amount. Examples of schools with such policies include Yale and Stanford.
- **Pell grant match.** These policies match the student's Federal Pell Grant. This significantly reduces but does not eliminate the self-help level. Examples of schools with such policies include the University of Minnesota system.

Two real-life examples of a No-Loan Financial Aid Policy

- **Bowdoin's No Loan Financial Aid Policy**
    - In January 2008 Bowdoin Trustees, mindful of their commitment to making a Bowdoin education as accessible as possible, voted to eliminate student loans from the financial aid package and replace them with grants for all current and future students. After the family covers any EFC (Expected Family Contribution) the college provides work-study and grant aid to cover school expenses.

- **Stanford's No Loan Financial Aid Policy**
    - In January 2008, Stanford University announced the largest increase in its history for its financial aid program for undergraduates. Under the new program, parents with income of less than $100,000 will no longer pay tuition. Parents with income of less than $60,000 will not be expected to pay tuition or contribute to the costs of room, board and other expenses. Students will still be expected to contribute their earnings from work during the summer and academic year.

Parents and Students should be alert

While Williams and Dartmouth are the only two schools to date to revert back to having loans in financial aid packages, the overall negative market impact on college endowments (down 18.7% in 2009) will most likely cause some of the other 70 plus schools to reconsider their policy as well. Those students choosing their school based on the no loan or limited-loan promise will need to carefully observe what takes place over the next few years. Remember, getting admitted to some of these no loan or limited loan schools will be the hardest part. Try to explore every option available to you.

A few resources for you…

www.finaid.org- this site has a list of the no loan schools as well as the criteria. In addition it is a great resource for all things related to financial aid.

www.projectonstudentdebt.org- The Project on Student Debt is a nonprofit research and advocacy initiative to raise awareness about the implications of student debt and advance policy solutions that increase educational opportunity and reduce the burdens of student debt.

INSIDE THE MARKETS FRANCIS J. DAVIES III

The Price of Ignorance

> *Any intelligent fool can make things bigger and more complex... It takes a touch of genius - and a lot of courage to move in the opposite direction.* **Albert Einstein**

If there was a spark of genius in any bill being considered by the Congress, it would soon be doused by the torrent of money that shapes the reasoning in our capitol, where the only courage to be found is focused on reelection. This is the rationale for flaccid legislation like the current financial reform package. For the 18 months it took Congress to get this bill to the floor, a parade of financial industry executives (and their highly paid lobbyists) warned that any new regulation could mean the death of American capitalism. Their campy overacting was rivaled only by the Oscar worthy performances of "injured" World Cup players.

Despite these dire predictions, the bill provides very little real consumer protection. It is not completely without merit, but any substantial benefit has been diluted to the point of irrelevance. Once again, the public has been left on their own. The way to survive is education. The following information does not make for light reading, but you should become familiar with where we are and how we got here.

The first lesson is no surprise: lobbying gets results. JP Morgan spent $7 million on lobbying in 2009 while Citicorp spent $5.5 million. This year, Goldman Sachs and JP Morgan had spent roughly $1.5 million apiece as of the end of Q1. Predictably, the bill fails to address the issues most important to these huge "Too Big to Fail" firms: the excessive risk-taking and mind boggling leverage that were at the core of the economic collapse.

Also left on the cutting room floor was the fiduciary standard. This subject was a hot topic when it was revealed that Goldman Sachs had been betting against securities it was selling to its customers. At issue was whether Goldman was acting as an investment adviser and therefore obligated to put the best interests of its customers ahead of its own, or if it was simply a broker executing an order and had no further duty to inform the client of the firm's conflict of interest. It is not a level playing field. Esoteric, customized products like structured CDOs require very specific deal knowledge. Without it, there is little hope to grasp the mathematical modeling devised by the MIT PhDs structuring the terms.

Senator Collins attempted to have someone from Goldman explain how they viewed their responsibility. When asked, three Goldman executives gave her three conflicting answers.

The confusion would have been cleared up had the fiduciary provision survived. Instead, the idea of forcing brokers to put the client's interest ahead of their own will be studied for six months by the SEC.

The touted Consumer Financial Protection Bureau (CFPB) is a decent idea hamstrung by being inside the Federal Reserve. It was intended to help consumers deal with predatory lending, excess fees, overcharging and the hidden charges found in the footnotes of every sales contract. For example, automobiles are the second largest purchase most people will make. The financing options – lease, purchase, finance - are far from simple. Many consumers do not realize they can shop for a better deal on their auto loan. The auto dealers' lobby applied enough pressure to keep their business exempt from the CFPB.

Recent polls show the lack of financial literacy within the American public. The CFPB might turn out to be helpful, but it is no substitute for education. Poor regulation did not cause the American consumer to triple our debt load as we binged on underpriced products from Asia using borrowed money. We cannot hope to stay ahead of the financial innovation coming out of the big banks.

Speaking of "Too Big to Fail" banks, ironically, we now have fewer banks with more assets than before the crisis. Senator Sherrod Brown noted, "Fifteen years ago, the assets of the six largest banks in this country totaled 17 percent of GDP ... <u>The assets of the six largest banks in the United States today total 63 percent of GDP</u>." Bank of America, JP Morgan, Citigroup, Wells Fargo, Goldman Sachs and Morgan Stanley now control $9.4 trillion in assets.

The banks' fierce lobbying also succeeded in emasculating the Volcker rule. In its original form, as proposed by Paul Volcker, the 82-year-old former Federal Reserve chairman, it would have banned banks from running private-equity and hedge funds. While not a return to the Glass-Steagal distinction between commercial and investment banks, it would have been a minimal step in addressing the risk-taking that fueled the financial crisis. Instead, a compromise was negotiated which limits these holdings to 3% of the bank's assets. This "limit" is higher than bank's current holdings in this area.

As you will remember, the present economic predicament was triggered by the inelegant death of the housing bubble. This led to the collapse of the Alt-A and subprime mortgage markets in 2007 and exposed the unconscionable risk-taking by the largest financial firms which were leveraged to the teeth. Bad mortgages were sold to firms who in turn packaged them and sold them as securities that paid 3 or 4 percent more than prime loans. Ratings agencies made a fortune judging these collections of bad loans to be solid gold investments. The bonds were then bought by big investors hungry for yield.

In the 2,300 page reform bill, the only part that might have helped prevent this is the tighter mortgage underwriting. Lenders must now verify the income, credit history and employment of borrowers. You may well ask, through clenched teeth, "Why wouldn't that already be standard practice?" As we have discussed before, mortgage originators were not lending their own capital. They were interested only in getting the loan closed and sold so they could get to the next deal. Several studies have shown that subprime loans were pushed in poorer communities, often to borrowers who could qualify for prime loans with better terms.

The poster child for these shady practices was Countrywide Financial. They were one of the biggest originators of Alt-A loans in the country as well as the largest servicer of subprime mortgages. (In April, Countrywide disclosed that it had reached an agreement to pay $600 million to settle the securities class action.) Fannie Mae and Freddie Mac played a key role in building the subprime disaster. These agencies do not originate mortgages. Their role is to provide liquidity in the marketplace by purchasing conforming loans which are either kept in their portfolio or packaged into mortgage-backed securities (MBS) which are sold to investors. Less known is the “guarantee service” they provide which essentially insures riskier pools of mortgages which makes them saleable. Starting in 2005, both agencies began to insure ever larger amounts of mortgage pools. This insurance was the jet fuel that launched the subprime market into overdrive.

Countrywide Financial was Fannie Mae’s largest customer, yet neither Fannie Mae nor Freddie Mac are mentioned in the reform package. Both spent big money on lobbying.

The large brokerage firms bought the majority of the remaining loans, pooled them together and sold them as MBS. Their motivation and vested interest was also to get the deal done, sold and get on to the next one. You may see the problem here. There is no price to pay for selling garbage. The reform bill tries to address this by making issuers of MBS retain 5% of the credit risk of the underlying assets of the pool – which is a start. The devil that is in the details: it is far from clear how this will be accomplished or if 5% is enough skin in the game to improve the quality of the pools. In one recent settlement, Merrill Lynch agreed to pay $475 million in cash to the Ohio State Teachers’ Retirement System. If that kind of penalty does not motivate good behavior, 5% ownership may not matter.

Also untouched by the bill are the credit rating agencies. The basic business model of debt issuers paying the agencies for ratings is left unchanged despite the enormous conflict of interest in the system. During the bubble, agencies fell over each other to bestow higher ratings than warranted in order to get future business from the issuer. The only proposal the bill does make is for a two-year study period. In testimony before Congress, the CEO of Moody’s, Raymond McDaniel, had this to say, “Moody’s is certainly not satisfied with the performance of these ratings,” and that investors should use ratings as a tool, “not a buy, sell or hold recommendation.” A tool is a means of accomplishing a task or purpose – like a saw or a compass. A compass that points in a random direction is really not a very useful tool.

In theology, we learned there are two types of ignorance. Negative ignorance is when you don’t know but think that you do. Positive ignorance is knowing that you do not know and wanting to learn. After 30 years in the financial markets, I appreciate that there is always more to learn about the markets and the global economy. It is never boring.

This quarter, there seemed to be a wide ranging group of topics to write about. Selecting one was difficult, so I asked myself "what's the easiest way out?" especially considering I was up against my editor's deadline. Then it hit me: a Question and Answer column! Short questions, simple answers, different topics, readers might actually stay interested – that's a home run. So here goes – welcome to the Fiduciary Corner's inaugural question and answer column. Today's topics: Platform and vendor differences, and a new way to look at Morningstar ratings.

QUESTION: All the 401(k) and 403(b) retirement plan platforms that I look at appear to be essentially the same. What are the primary comparisons I should make when I review which platform or vendor is the best for my participants?

ANSWER: On the surface, they appear to be similar. They all offer investment options, they all provide marketing and basic education brochures, they all have websites that participants and plan sponsors can use to check their balances. Many platforms excel in a particular area; none are good at everything they do. However, there are tremendous differences if you peel away the outer wrapping. Some of the important areas you should compare:

- **Investment options** differ greatly in available share class, variety, fiduciary quality, performance history, performance potential and cost. Ostensibly, the easiest between- platform comparison to make. Realistically, the most difficult pure "apple-to-apples" comparison to make.
- Dedication to **participant education**, educational materials and available resources for enrollment meetings and individual advice varies widely between platforms. Critical to the long-term success of your plan, well-executed and well-maintained education programs are a significant cornerstone.
- Some platforms provide in-house **recordkeeping** (bundled), some farm out the recordkeeping (unbundled). Sometimes it comes down to a choice between the centralized, technology-based national approach versus the service-oriented local approach. You need to pick what support option works best for your particular situation.
- Some vendors offer to be plan trustee, some offer access to a trustee, some refuse to do anything related to the word "**fiduciary**". An important component in the past 20 years, a consultant or vendor who is a plan investment fiduciary makes decisions in the best interests of the client. A VERY important component as we go forward in light of the financial reform bill passed on June 28th.
- **Fees and expenses** related to plan platforms come in many different shapes, sizes and flavors, visible and hidden. The "all-in" fee, otherwise known as "how much your plan is really costing you", runs as little as *half a percent of assets to upwards of three percent of assets*. It includes investment expenses, marketing costs, recordkeeping fees, and accounting, legal and fiduciary bills. How much does your plan cost you?

Without the help of an unbiased third party, it's an onerous task to figure out which platform is the best value for you and your participants. Work with someone who is not paid by the investment products or platforms they are selling if you want a truly unbiased opinion. An unbiased Advisor will look at what is in your best interests and which components of a platform are the most important to your plan. Not how they are being paid.

***Question:* What are Morningstar's star ratings?**
ANSWER: From Morningstar Principia:

> *"The Morningstar Rating for funds, commonly called the star rating, is a measure of a fund's risk-adjusted return, relative to similar funds. Funds are rated from one to five stars, with the top 10% of performers in each Morningstar Category receiving 5 stars and the bottom 10% of performers receiving 1 star. Funds are rated for up to three time periods--three-, five-, and 10 years-- and these ratings are combined to produce an overall rating. Funds with less than three years of history are not rated. Ratings are objective, based entirely on a mathematical evaluation of past performance.* ***They're a useful tool for identifying funds worthy of further research, but shouldn't be considered buy or sell recommendations****."*

***Question:* Should I rely on the Morningstar ratings when I am selecting a new fund for my plan, or doing a comparison of my plan's platform with a new platform?**
ANSWER: No. I highlighted the last sentence in the previous answer in bold, because even Morningstar says not to make buy or sell recommendations based on their ratings. Yet, at least once a month we see a fund recommendation that lists the star ratings prominently and markets a platform change based on them. Why? Three reasons: they are visibly identifiable; consumers think they understand them; they imply some kind of fiduciary screening. In short, they tell a good story for the salesperson to sell. In our view, any recommendation should include well thought out analysis of why the fund (or funds) fits your plan needs. At a minimum, it should include the following components: risk analysis, return forecast, style fit, and plan compatibility. There needs to be a compelling reason for a fund to be selected as a long-term investment option for participants. This goes beyond the star rating. Anything else is your broker/salesperson cherry-picking what will show best on paper.

***Question:* Are Morningstar ratings useful?**
ANSWER: Yes. They are based on past performance, using risk-adjusted returns, and compare the fund being rated to all other funds in its category. From Morningstar Principia, the ratings are:

> *"…calculated by subtracting a risk penalty from each fund total return, after accounting for all loads, sales charges, and redemption fees. The risk penalty is determined by the amount of variation in the fund's monthly return, with emphasis on downward variation. The greater the variation, the larger the penalty."*

Note the references to risk and volatility (variation). Most people think the star rating is tied to investment performance. We would rather think of it as relative performance - relative to risk, relative to volatility, relative to other similar funds, relative to indices. So what do the ratings tell us as fiduciary consultants?

Morningstar ran an interesting study. They wanted to know if the star ratings reflected any particular type of strategy, style, or philosophy. They compared all funds that had "star ratings" (see table below). According to Don Phillips, a Managing Director at Morningstar, one of the results that this comparison generated was this: *"…the ratings favor lower-risk funds…lower-volatility funds are much more likely than higher-volatility funds to keep investors on board to realize the benefits of ownership."*

Simply put: less expensive funds with lower volatility (ideal for long-term investing in 401(k) and 403(b) plans, no?) have performed better on a risk-adjusted basis and received higher ratings over time. Still not enough reason to be included as a plan option, but a solid underpinning, and a good place to start your fund analysis.

Star Power

Star Rating	3-Yr Total Ret(%)	3-Yr Investor Ret(%)	3-Yr Stand. Deviation	Exp Ratio	Front Load (%)	Back Load (%)	Turnover (%)	Tenure (Yrs)	Manager Investment
5	1.02	1.32	16.57	1.14	0.29	0.22	112	6.2	$300,061
4	−1.36	−1.84	17.52	1.21	0.51	0.39	90	6.3	$250,890
3	−3.10	−5.62	18.26	1.27	0.73	0.54	123	5.4	$161,602
2	−4.62	−5.86	18.71	1.43	1.08	0.86	123	4.6	$124,810
1	−7.65	−8.69	21.31	1.55	1.12	1.01	146	3.8	$110,991

Data as of Jan. 31, 2010

IMCG NEWS

FRED WILLIAMS – Fred was recently elected Treasurer of Opportunity Farm for Boys & Girls at the organization's annual meeting in June. He joined their Board in 2009 and chairs the Finance and Investment Committee.

STEVE EDDY – Steve has been asked to join the Board of Directors for the Institute for Civic Leadership, an organization he has served in many capacities over the past few years. He also just completed another successful season as coach for the very competitive Scarborough Girls tennis team, which finished the season with a 10-4 match record and made the Western Maine semifinals, in addition to wrapping up his debut with the USM Men's team, which lost to eventual champion Western Connecticut in the Little East semifinals

FRANCIS J. "TERRY" DAVIES III **-** Has been asked to join the board of directors at the Institute for Financial Literacy; a non-profit organization whose mission is to make effective financial literacy education available for all American adults. The Institute advances professionalism and effectiveness in the field of financial literacy and hosts the Annual Conference on Financial Education. Mr. Davies recently completed level four of the four part process to become a Certified Divorce Financial Analyst and has begun the course work for earning a Certified Financial Planner (CFP) designation. The CFP is a professional certification mark for financial planners conferred by the Certified Financial Planner Board of Standards, Inc.

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:

> ***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.
>
> **The Little Dolphin School** is having its **4th Annual Golf Tournament** on September 17th at Val Halla Golf Course in Cumberland. The Little Dolphin School Foundation has been a national leader in early childhood education since 1977, and the Foundation's scholarship and tuition assistance program is dedicated to solving a currently existing crisis of finding high-quality childcare services for low to moderate income families. A Maine-based non-profit organization, their learning centers in Scarborough and Westbrook, serve over 200 families per year in the Greater Portland Area.