INVESTMENT MANAGEMENT & CONSULTING GROUP

VIEWPOINTS

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MARKET COMMENTARY — FREDRIC W. WILLIAMS

It's the Demography, Stupid…

To paraphrase, perhaps poorly, James Carville's early 90's presidential political slogan, what may be one of the more important factors in both the domestic and global economy over the next decade with regard to the prospects for growth and productivity advancements, not to mention sovereign debt burdens, could be demographics. Although a global reality, as well as the main dichotomy between the developed and developing world, this is timely from a domestic standpoint in that 2011 represents the year that the first of the baby boom generation hits 65 and theoretical "retirement" age. In the U.S. alone 2.8 million people become eligible for Medicare benefits as of the first of the New Year, and then can start drawing full Social Security checks next year. In fact the longer projections are a tad daunting – by 2012 it's expected that approximately 10,000 people per day will hit 65, and that it will keep happening for the next 19 years.

> *"No other force is likely to shape the future of national economic health, public finances, and policymaking as the irreversible rate at which the world's population is aging. The problem has been long observed and is well understood: United Nations figures show the proportion of the world's population aged over 65 is set to more than double by 2050, to 16.2% from 7.6% currently. By the middle of the century, about 1 billion over-65s will join the ranks of those classed as of non-working age…S&P believes that the cost of caring for these people will profoundly affect growth prospects and dominate public policy debates worldwide."* Standard & Poor's 10/20/2010

Not only will the debate center on governments' ability to pay for the promises made in the past (as we've recently seen play out in Europe), but this dynamic will impact our current recovery efforts as well as the pace of future global economic activity. Last year was anticipated to be the first year in the U.S where we paid out more in Social Security benefits than we collected in payroll contributions, a condition that some argue is already the case with Medicare. With the ratio of workers paying in to the system versus retirees taking benefits out of the system declining, the math seems to point toward either an increasing deficit or a decrease in benefits. An uptick in the federal deficit crowds out the capital available to invest in economic growth (via a lack of investment capital and/or increasing interest rates) while a decrease in benefits crimps the wallets of retires and compromises their ability to contribute to our GDP from the consumer spending standpoint. Either way this aging dynamic from a domestic standpoint does not appear to be accretive to the nascent recovery that may be taking hold.

Additionally, an aging population reduces aggregate demand – the need or desire to acquire goods and services – given that they likely are existing on a fixed income and are downsizing as empty nesters transitioning into retirement. The more people who are retired and the fewer that are working can also constrain growth as fewer people are productively contributing to our gross domestic product, thereby presenting headwinds to increases in economic activity.

> *"Achieving that level of economic activity [the 3-4% GDP growth projected as necessary to reduce our unemployment rate], however, isn't as easy for the U.S. today as it was a decade ago. Thanks in large part to slowing growth in the U.S. population, which is also aging, Bank of America Merrill Lynch estimates potential gross-domestic-product growth, after inflation, is now only about 2.3% annually. By comparison, GDP grew by 3.8% on average in the 1990s and 2.7% during the last expansion from 2002 through 2007.*
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> *Even if the year does start off with annualized growth near 4%, it may prove difficult to sustain. Stronger growth carries side effects, like higher interest and mortgage rates, at a time when the fragile housing market can ill afford them. It boosts the dollar relative to other currencies even as policy makers look to bolster exports. It puts upward pressure on food and fuel costs before consumers can fully absorb them."* *WSJ 1/3/2011*

By and large these issues are the bailiwick of the developed world and its older populations while the emerging/developing world, in addition to being more populous, is also younger (although China's "one child" policy is accelerating its aging ratio) and therefore is, and will be, experiencing the flip side, and more positive aspects, of the demographic dynamic. They have an expanding middle class, and therefore an increasing internal aggregate demand as families are built and more goods and services are acquired, along with a larger work force to retiree ratio. Their export driven economies (based initially on their low relative labor costs) have generated significant surplus reserves which have insulated them, for the most part, from the recent financial turmoil. From a global perspective, the challenge we presently face is that all this positive news is the developing world doesn't provide the scale of aggregate demand (think a motor scooter trying to pull a broken down tractor trailer back on to the highway) to drag the U.S., Europe and Japan out of their lethargic recovery.

This is not presented as the death knell for the developed world or a ringing endorsement of the emerging markets. Instead it's an attempt to look at structural realities that will need to be addressed, despite the political posturing to the contrary, for both constituencies to move forward. Neither camp can completely exist without the other, so a more level playing field and balanced trade practices will need to evolve so the globe's challenges can be efficiently addressed.

Although not as exciting as waiting to dissect the most recent economic data release or earnings announcement, the glacial impact of country-specific and global demographic trends may provide patient investors with an understanding of how effective asset allocations should be structured to take advantage of the world's macro trends going forward…just don't expect Mad Money or Fast Money to do a segment on this topic anytime soon.

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Sprint to the Finish…

Responding to existing, as well as promised, fiscal and monetary stimulus, almost all the planet's equity markets advanced in 2010, with the bulk of that advance domestically resulting from the Dow's 7.3% surge in December alone. In a year that saw multiple periods where many of the globes equity markets were correcting or in the red, continuing support from the world's central banks, via suppressed short term interest rates, was the fuel that lifted most stock markets into positive territory for the year. After facing numerous head winds, from sovereign debt issues to double-dip recession concerns, the combination of the Fed's quantitative easing announcement (see comments below in next article) and the realization that the mid term election results might be breaking the partisan tax policy grid lock in a constructive fashion, drove the equity indices higher as we closed out the year.

Hitting mid-2010 in the red as a result of a bout with the "swine-flu" (the Greece bail out and resulting concern about the other PIIGS's debt problems), the markets generated all of their positive returns in the second half of the year. The Dow Jones Industrial Average continued its summer rally, up 7.52% in the 4th quarter and 11.02% for the year, while the broader S&P 500 moved ahead 10.5%, advancing 12.8% through the four quarters, and the NASDAQ jumped 12.6%, finishing 2010 up 17.4%.

The fundamental backdrop for this market recovery has been gradually improving economic data and robust corporate profits, as well as repaired corporate balance sheets estimated to be sitting on in excess of $1 trillion in cash. This misery deployment of earnings has been attributed to corporate concerns about access to bank credit and uncertainty about what new regulation and/or tax might be rolling out of the hallowed halls of our nation's capital. Given that both of these fears appear to be abating it's argued that the late year rally was in response to move favorable lending availability and better clarity, post the elections, of how the overall tax situation is going to unfold.

> *"The reasons the bulls are bullish are also pretty universally agreed upon. The industrial economy has gathered some momentum, the emerging markets are surging, companies are flush, profits look set to rise decently again, the Federal Reserve is seeking new ways to penalize risk aversion, taxes won't go up and the market tends to do well in the year after a midterm election.*
>
> *"And we can add to the list the likelihood that another financial-engineering cycle is just getting into gear, so expect lots of equity-friendly refinancings by stretched companies, re-leveraging by cash-rich ones and buyouts hither and yon.*
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> *"The thing is, it's all pretty much true. And because of that, and given that stock valuations are not excessive, it's tough to think a likely pullback or worse would signal some major top."* *M. Santoli, Barron's 1/3/2011*

The fly in the ointment continues to be the jobs situation and the condition of the housing market, as over the longer term they are inextricably linked to a growing GDP. Whether you look at it from the perspective of a healthy housing market creating jobs, or employed homeowners better able to pay their mortgage and stay in their homes, both of these challenges will need to see some improvment in the new year if corporate profit growth it to continue. As we mentioned in the past, our GDP is more than 2/3 attributable to consumer spending – which requires that Joe and Jane Main Street not only have a job, but are employed to the extent that their bills can be paid. With headline unemployment stuck around 9.8%, and the more broad measure of U-6, which includes those who are underemployed (out of work investment bankers working as greeters at Walmart, for example), hovering at a staggering 17% of the civilian work force, it's conceivable that GDP will remain muted as we muddle through this recovery.

Overseas markets continued to be region and situation specific with regard to their performance, although most of the globe's bourses advanced in 2010 as well. In the developed world London's FTSE 100 rallied 6.5% in the quarter, hitting year end up 9%, Frankfurt's DAX leapt 11.4% and was the leader in the clubhouse with a 16% advance for 2010, while the Paris CAC 40 continued to struggle slipping 8.9% for the quarter and 3.3% for the year and Tokyo's Nikkei finished the quarter up 7.4% but was still off 3% for 2010. Within Europe, the peripheral PIIGS were the weak links, as could be imagined given the debt drama they've been wrestling with, resulting in stock market declines ranging from down 3% in Ireland to more than 35% in Greece.

> *"Global stock markets dodged a gauntlet of worries—including two lurches to the brink of disaster in Europe and near-constant worry of a double-dip recession in the U.S.—to ring up post-crisis and all-time highs.*
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> *"Whether that run can continue in 2011 will depend on a delicate mix of good news: a steadying U.S. recovery, sustained economic growth in emerging markets and the absence of any major shocks from Europe, the Korean peninsula and elsewhere.*
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> *"It is also possible that global investors will have to cope without a key tail wind driving the market rally for much of 2010, namely the help of the Federal Reserve. The flood of cash unleashed by the U.S. central bank ended up pumping up asset prices around the world. But with the economic benefits of easy money likely to be more muted, the onus is greater than ever on a steadying global recovery.*
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> *"For emerging economies and their stock markets to continue outperforming, strategists agree that increasing domestic demand will be an important piece of that puzzle. The developed world, beset by debt and other fiscal problems, can no longer be counted on to drive global growth with consistency."* *J. Cheung WSJ 1/3/2011*

The developing world's stock markets continued to out perform, but within the BRIC complex returns were more diverse as localized issues began to impact market developments. Brazil, likely the most robust economy in South America, was flat for the quarter and up only 1% for the year, while Russia road the commodity wave and jumped 22.7% in 2010. India, probably the most balanced of the group, advanced 17.4%, while China, starting to see some of the air come out of the Sino-bubble, closed 2010 down 14.3%.

Although we believe that the end-of-2010 sprint may have already discounted the impact of QE2 and a change in the U.S. Congress, we see the first half of the new year as potentially more challenging, and would use any market weakness to accumulate income producing equities which we find quite attractively valued at this juncture. As noted previously, the deleveraging continues, for both individuals and institutions, and 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

Awaiting the Rate Escalator…

After a roller coaster year, the credit markets ended up turning in mixed results as corporate bonds continued to advance in price (with yields declining) while Treasurys and munis suffered through, for differing reasons, one of their worst 4th quarters in decades. Investor appetite for yield was the driving force as investors added risk via their migration from investment grade corporates to high yield and emerging market debt. U.S. Treasurys and municipal bonds suffered amid concerns about the Fed's accommodative rate policy and quantitative easing, while municipals were hit with worries about the ability of states to pay their bills in the face of diminished tax receipts.

Mid year market concerns prompting a flight to the dollar, as well as whispers about the potential for the Fed's next round of bond purchases to inject liquidity into the economy, dubbed "QE2" by the talking heads, pushed yields down before structural concerns about the magnitude of federal and state debt caused rates to back up markedly as we exited 2010.

Although the consensus for most of the year, as well as the outlook for 2011, had anticipated rising rates, bond yields actually closed the year slightly lower than they started, for the most part.

> *"Ravenous demand pushed the average yield on new bonds rated single-B down to 8% to 8.5% in the last quarter of 2010, compared to around 10% a year earlier and to over 12% during the worst of the credit crunch, according to Standard & Poor's Leveraged Commentary and Data. The average spread of investment-grade bonds over Treasurys compressed to 1.71% in 2010 through November, down from 2.1% in 2009 and 6.3% in 2008, according to data from Barclays Capital."*
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> *"Despite the late-year scare and a roller-coaster ride throughout the year, yields (on the 10 yr. Treasury) ended 2010 slightly lower, down from 3.83% at the end of 2009."*
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> *WSJ 1/3/2011*

As noted previously, the 4th quarter was not kind to the government bond market as Treasurys of all maturities lost nearly 3% in total return – something which was a bit of a surprise to the legions of retail investors who yanked money out of the equity markets post the "flash crash" in May thinking that the bond market might offer them shelter from the next market storm. The 2-year note closed the year yielding 0.605%, up from 0.43% at the end of September, while the 10-year note touched 3.5% in December before closing at 3.299%, up from 2.519% at the start of the quarter. Our old "retired" friend, the 30-year bond, also saw its yield back up from 3.684% to 4.336% as we exited 2010, causing its total return to decline 12.92% for the year, according to Barclays Capital. Even the staid municipal bond market, which we think represents some real selective value now, closed the quarter with 10-year triple-A paper yielding 3.16%, almost at parity with the Treasury even before accounting for its tax free benefits.

All of these market developments flew in the face of the Federal Reserve's widely anticipated early November announcement of its next round of quantitative easing, which is designed to push interest rates lower by adding to the money supply via lending in the banking system.

> *"In its latest move to jump start the sluggish recovery, the Federal Reserve announced it will pump billions into the economy.*
>
> *"The central bank will buy $600 billion in long-term Treasuries over the next eight months, the Fed said Wednesday. The Fed also announced it will reinvest an additional $250 billion to $300 billion in Treasuries with the proceeds of its earlier investments.*
>
> *"The bond purchases aimed at stimulating the economy -- a policy known as quantitative easing -- will total up to $900 billion and be completed by the end of the third quarter of 2011."* *CNN 11/3/2010*

As of the end of the year, the Fed had committed about $179 billion of its new $600 billion war chest, pushing the Federal Reserve's balance to slightly more that $2.4 trillion, up from $869 billion in August of 2008, based on data obtained from the Board of Governors' web site (www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm). This is a stark contrast to the jawboning at the start of the year when the chatter centered on when the Fed would be *exiting* the bond market and shrinking its balance sheet. But with employment and the housing market, as well as the resulting economic activity both contribute to our nation's gross domestic product, in the cross hairs it appears that government intervention "for the indefinite future" is still going to be a bond market reality as we enter the new year.

The tug of war going forward will be between attempts to stimulate a rather moribund economy and the potential for unintended consequences like rising interest rates or a weakening currency. Rising rates would not bode well for our still comatose housing market, while the impact of a less than robust dollar can be debated – although sometimes not publicly with our trading partners. A weaker dollar could contribute to the importing of inflation with the cost of goods (think oil, for example) rising as the currency sinks, while that same weaker currency could make the cost of our exported goods cheaper and more competitive on a relative basis, vis-à-vis other countries and their exports. This, however, comes at a political cost as our very inter-connected and trade-oriented globe tries to make sure that currency "manipulation" (consider our China conundrum) does not become a factor in the flow of free trade.

Given these developments, as well as our expectation for rising rates within the next 12 to 24 months, we close by reiterating our comments from 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."*
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> *IMCG "Viewpoints" Q3 2010*

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New Law Extends Bush-Era Tax Cuts, Reinstates Estate & Gift Tax

On December 17, 2010, President Obama signed into law the **Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010**, or H.R. 4853 (hereafter, "the Act"). The bipartisan legislation extends for two additional years many of the so-called "Bush-era tax cuts" originally enacted under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

Key provisions of the new law extend the individual and capital gains/dividend tax cuts for all taxpayers through 2012, enact a payroll tax cut for 2011, provide a two-year AMT patch, and establish a top estate tax rate of 35 percent with an exclusion of $5 million. Below are highlights of the act.

Individual Income Tax Rates

The Act extends all individual income tax rates at their 2010 levels for two additional years through December 31, 2012. Under EGTRRA, the rates were originally scheduled to revert to pre-2001 levels beginning January 1, 2011. The 35-percent tax bracket will continue to be the top rate. Extending these rates further will likely be a contentious issue in the 2012 presidential election campaign.

Capital Gains/Dividends Tax Rates

The Act extends the current maximum tax rate for qualified long-term capital gains and dividends (i.e., 15 percent for most taxpayers, and zero percent for taxpayers in the 10-15 percent tax brackets) through December 31, 2012.

Qualifying dividends are those dividends received from a qualified domestic or foreign corporation, on which the underlying stock is held for at least 61 days within a specified 121-day period. The Act also extends the qualified dividend treatment for dividends passed through from a regulated investment company (RIC), real estate investment trust (REIT), or other qualified pass-through entities.

Payroll Tax Cut

The Act reduces the employee-share of Social Security Old-Age, Survivors, and Disability Insurance (OASDI) taxes from 6.2 percent to 4.2 percent for wages earned in 2011 up to the taxable wage base of $106,800. The employer's share remains at 6.2 percent. Likewise, the share for self-employed individuals is reduced 2 percent down to 10.4 percent of income up to the threshold.

Alternative Minimum Tax (AMT) Patch

The Act includes an AMT patch, increasing the exemption amounts for 2010 to $47,450 for individuals, $72,450 for joint filers, and $36,225 for married taxpayers filing separately. For 2011, the exemption amounts increase to $48,450, $74,450, and $37,225 respectively.

Relief from the Marriage Penalty

The Act increases the basic standard deduction for a married couple filing jointly to twice that of a single individual through December 31, 2012, effectively extending relief from the marriage penalty as originally provided under EGTRRA. The Act also continues the expanded size of the 15-percent bracket for married couples filing jointly to twice the size of the bracket for single filers.

Child Tax Credit Extension

The Act extends the $1,000 child tax credit for two years through December 31, 2012, including enhancements made to the credit by EGTRRA and subsequent legislation. The credit continues to phase out for taxpayers with adjusted gross incomes of $110,000 for joint filers, $75,000 for other filers.

Tax Incentives for Education

The Act extends the following tax credits and deductions related to education expenses for two years through December 31, 2012, subject to the same income limitations and phase-out guidelines as before:

- The American Opportunity Tax Credit (AOTC)
- The exclusion of employer-provided education assistance (up to $5,250) from income and employment taxes
- The 60-month rule for the $2,500 above-the-line deduction for student loan interest deduction
- The $2,000 maximum contribution amount for Coverdell Education Savings and the eligibility of primary and secondary school expenses as qualified expenses

Residential Energy Property Credit

The Act extends the residential energy property credit, with some limitations, for one year through December 31, 2011. The credit is equal to 30 percent of the sum of expenditures for qualified energy-efficient improvements and property, limited to $500. Qualified property includes exterior windows and doors, water heaters, insulation, furnaces, and other qualifying purchases.

Other Tax Extenders for Individuals

The Act extends the following provisions, most for two years through December 31, 2012:

- EGTRRA's repeal of the personal exemption phase-out
- EGTRRA's repeal of the Pease limitation on overall itemized deductions
- EGTRRA's increased adoption credit dollar limitation and income exclusion for employer-paid or reimbursed adoption expenses of $10,000
- Enhancements made to the Earned Income Tax Credit (EITC) under EGTRRA and subsequent legislation
- Enhancements made to the dependent care credit under EGTRRA
- Mortgage insurance premium deduction (extended for one year)

The Act also extends the following incentives, which had expired at the end of 2009, for two years through December 31, 2011:

- State and local sales tax deduction
- Higher education tuition deduction
- Classroom expense deduction for teachers
- Exclusion from income for charitable contribution of IRA proceeds
- Deduction for charitable conservation contributions of appreciated property
- District of Columbia first-time homebuyer credit

FEDERAL ESTATE & GIFT TAXES

The federal estate tax was scheduled to revert to its pre-EGTRRA levels (i.e., a maximum tax rate of 55 percent and a $1 million exclusion) beginning January 1, 2011. The Act reinstates the estate tax for decedents that die after December 31, 2009 but before January 1, 2013 at a maximum rate of 35 percent with a $5 million exclusion. The exclusion amount is adjusted for inflation for decedents that die in 2012. The Act also replaces the modified carryover basis rules with the stepped-up basis rules that were applicable until 2010.

The Act grants estates of decedents that die after December 31, 2009 but before January 1, 2011 the option to elect whether or not to apply either the reinstated estate tax (i.e., the 35-percent maximum rate and $5 million exclusion) with stepped-up basis, or no estate tax with the modified carryover basis rules allowable for 2010 under EGTRRA. The Act further grants the estates of decedents that die after December 31, 2009 and before December 17, 2010 additional time to file any return or make any payment.

The Act also provides for some portability of the maximum exclusion between spouses after December 31, 2010. This provision allows a surviving spouse to increase his or her maximum exclusion amount by claiming the unused portion of his or her deceased spouse's estate tax exclusion.

This opportunity, which effectively enables married couples to protect up to $10 million, is only available when the proper election is made on a timely filed estate tax return. Should a surviving spouse be predeceased by more than one spouse, the exclusion amount would be limited to the lesser of $5 million or the unused exclusion of the most recently deceased spouse.

Additional Extended Provisions

The Act extends the following provisions, most for two years:

- EGTRRA's state death tax deduction
- EGTRRA's provisions regarding conservation easements
- EGTRRA's provisions regarding small and family-owned businesses
- the availability of estate tax installment payments for closely held businesses

Gift Tax Rate

For gifts made in 2010, the Act provides a gift tax rate schedule that has a maximum tax rate of 35 percent with a $1 million exclusion. For gifts made after December 31, 2010, the Act recouples gift and estate taxes to apply a maximum rate of 35 percent with a $5 million exclusion.

Generation-Skipping Transfer (GST) Tax

The Act extends some technical provisions enacted under EGTRRA that effect the GST tax, and provides an exemption of $5 million (equal to the estate tax exclusion) with a GST tax rate of zero percent for transfers made in 2010. For transfers made after 2010, the GST tax rate would equal the highest estate and gift tax rate in effect for the year in which the transfer occurs. For example, in 2011 and 2012, this rate would be 35 percent.

These EGTRRA extensions will obviously be factored into the collaborative work we will be doing with your estate planning attorney and tax preparation professional, while IMCG will including the taxation of investment income, as well as the AMT threshold, in our portfolio management and allocation planning going forward.

FIDUCIARY CORNER STEPHEN L. EDDY

Looking Backwards to Look Ahead

With apologies to any of my English professors and our reader's sensibilities, let's have some fun with analogies and tell a retirement plan story. The challenge is how to combine multiple metaphors and analogies and still sound coherent – think of the "dream within a dream within a dream" concept from the 2010 movie *Inception*. Let's imagine ourselves in an economics class in the year 2110. Our avatars (like the other movie) are on a virtual field trip visiting a weather-themed museum dedicated to the Great Recession of 2008 and 2009 (don't worry – I tie all of this together…).

The display opens with a review of market conditions in June 2007. Just like Oz after Dorothy kills the Wicked Witch of the East with her house, the sun is shining; the people are singing; the Dow is hovering around 13,500. Investing is easy, credit is abundant, and retirement plan participants are trying to figure out how much earlier than age 65 they can retire. Every person, employed and unemployed, can seemingly afford a house. Forecasters and prognosticators abound. Dow 25,000 anyone? Follow the yellow brick road…

The next display, August – October 2007, turns partly cloudy. Sub-prime loans are the culprit. American Home Mortgage collapses, and questions arise about Countrywide Financial's ability to survive, it being the largest mortgage lender in the United States. A credit crisis is brewing (as we would find out later, it had been for some time). The still-ignorant Dow moves above 14,000 in October, the all-time high up to that point. Although a concern, it's not viewed as much of a threat to our plans for retirement. Something has to give. Cue the ominous music…

As we move into the 2008 portion of the exhibit, we begin to realize we're not in a "feel-good" musical fantasy film, but what is starting to look like our very own horror movie. We notice some dark clouds forming. Bear Stearns fails in March. *"Don't worry – it's just an isolated thunderstorm",* the majority of the meteorologists say. "*Just a blip*", the stock market forecasters say. As the 2008 exhibit moves forward to the summer we learn that the credit ratings agencies (S&P, Fitch, Moody's) were not doing what they are chartered to do, namely provide accurate oversight and risk analysis on the credit market and its products. We start to hear whispers that there might be other, larger problems. The Dow retreats to around 12,000. *"We have a tornado watch in effect for the area. This means conditions are favorable for severe thunderstorms to produce tornadoes in and close to the watch area"*, says the Weather Channel. *"An expected pullback",* the market guru says.

The exhibit moves forward to September-December 2008. In our horror movie, we know what is going to happen; it's scary and ugly, but we can't turn away. Lehman Brothers fails. Merrill-Lynch is saved from imminent failure by a shotgun wedding to Bank of America. AIG is in trouble. Fannie-Mae and Freddie-Mac are in trouble. Everywhere you turn, there is bad news. The global financial markets are collapsing. World governments try to infuse liquidity into the system. *"We have a confirmed report of a massive tornado on the ground. This is likely an F5 tornado on the Fujita scale. This is an extremely dangerous situation. If you are in the storm's path you should immediately seek shelter",* says the weatherman. *"I was right",* trumpet two hundred of the ten economists who foresaw it. The market is in full-blown free fall, the Dow dropping to 8,000 (eventually dropping to 6,600 in March of 2009).

Our virtual museum tour field trip ends with the realization of the tremendous impact of this "perfect storm". Retirement balances drop 50% in some cases. People are out of work, using their retirement plan balances to survive. Many of the lucky ones, those with jobs, realize they can't retire when they had planned. *"It wasn't supposed to be like this. Nobody prepared us for this"*, is their refrain.

Now we're back in current day 2011. Where do retirement plans go from here? What did we learn from the events of the past few years? What is the next display in the museum going to look like? There has been an interesting evolution in participant behavior. Participants are paying attention and are being more vocal. They are looking much more closely at their retirement plans and realizing they need to manage this process, and they need the help and the tools to do it. They are asking more questions of plan providers and employers. They are wondering what could have been done to prevent, or at least minimize, this blindside hit to their retirement. They are seeing past the "everyone is in the same boat" excuse fed to them by many plan brokers. They are now examining plan platforms, fund options, plan fees, education and advice received.

What did they learn?

- For starters, all platforms and advisors are not created equally. Not every provider or broker does, or is required to do, what is in the best interest of their client. Most avoid any association with the term "fiduciary".

- Second, target-date funds were exposed as not the most properly disclosed or regulated investment options and were clearly a product created to enhance fee revenue and fund deposits for the fund families.
- Third, the term "co-fiduciary" had no meaning, other than as a marketing gimmick.
- Fourth, the gap range of advice given by brokers (plan balance specific) and RIA's (comprehensive wealth management) is huge.
- Fifth, most fund lineups were not created or monitored by an investment fiduciary.
- Finally, the term "free" has a cost associated with it. Plan costs are all over the map. American Funds has 7 different share classes for their funds that are commonly used in retirement plans. The only difference: the fees they charge or pass on to the broker/TPA. Which plan gets what share class, and when, is inconsistent and varies greatly among the providers and platforms, usually without a reasonable explanation.

When balances were in a seemingly constant upward climb, no one paid any attention to these issues. As their balances dropped, participants started pointing fingers. Many insurance companies, broker-dealers, and their brokers circled the wagons and went into a spin mode normally only seen in a contentious political election, and with good reason.

The Great Recession spawned many proposed legislative and procedural changes targeted at retirement plan service providers, particularly the aforementioned insurance companies and broker-dealers. Brokers of retirement plans, after years of making a great living being paid directly from participant balances and peddling only products that would pay them commission, found themselves in the crosshairs of an angry, more vocal public. Which any political opportunist knows eventually leads to an angry politician. Predictably, Congress reacted, not only to the recession-causing sub-prime and collateralized debt-obligation (CDO) mess, but to the brokers message that they were not fiduciaries to these plans and therefore not culpable for any mismanagement of them.

The proposed changes directly address how retirement plan services are delivered and how they are to be disclosed; they most directly impact the way brokers, broker-dealers, insurance companies and third-party administrators operate. Here's what we can look forward to in 2011:

- (1): Beginning July 16, 2011, service providers will have to ***disclose all forms of compensation received*** from retirement plans – direct (from the plan sponsor), indirect (from the fund companies for marketing/accounting services), shared (with another plan provider), and termination costs. This will be a big change for how recordkeepers and brokers do business, and may surprise some of their clients. This is mostly business as usual for Registered Investment Advisors.
- (2): The proposed definition of ***who is a fiduciary*** will probably be tightened by the SEC, but not without some opposition from broker-dealers and brokers. The likely impact will be that many brokers and broker-dealers either a) form RIA's (which are already governed by fiduciary standards) or b) have to clarify/prove very clearly in writing that they are not fiduciaries to the plans under the new definitions.
- (3): ***Target date funds*** will be required to have more disclosure, as they have been poorly communicated (at best) and deliberately misleading (at worst). At issue are the labeling (i.e. the "2015" fund) and what it means, marketing (how much do they cost, who should invest in them), and composition (what are the underlying holdings and is there a fiduciary standard in place for selecting the underlying holdings?).

- (4): An industry that requires the plan sponsor to have a formally documented ***customized review of plan expenses, plan investments, providers and platforms.***

Which, not so coincidentally, is where IMCG comes in…

INSIDE THE MARKETS FRANCIS J. DAVIES III

Risk Control - Regulation or Enforcement?

The housing price bubble, fueled by subprime mortgages, began to deflate in mid-2006. It is now almost 5 years since the peak in U.S. home prices. The results from the correction in that market continue to be a drag on the economy with unemployment in particular remaining stubbornly high. Most of the country has suffered from this downturn - with the glaring exception of the financial industry. In 2010, it again fought off an attempt at serious regulation. The industry's adversarial position is in direct contrast to our belief in total transparency.

We talk of fiduciary responsibility quite often at IMCG. While most industries are not held to that high standard, they are responsible to clean up their own messes. Contrast the treatment of Wall Street after the subprime disaster with British Petroleum and the Gulf of Mexico spill. BP was clearly held responsible for cleaning up the damage. While there remain disagreements about whether the penalty was sufficient to the damage done, there was a penalty. In Maine, we have the recent example of Sugarloaf Mountain taking positive steps to correct safety issues with its chairlifts.

The lesson of the 2008 mortgage crisis seems to be that no one was to blame, that no one could have foreseen it –as Alan Greenspan has stated. Yet plenty of investors did anticipate the looming trouble and avoided or even profited from the subprime mess. (For one example, see Fred's article "Sublime Sub-prime" in our market letter from the first quarter of 2007.) Rather than having to disgorge any of the immense profits that it made during the mortgage bubble, Wall Street was bailed out by taxpayer funds. And despite what Mr. Greenspan may say, several new books show that there were warning signs that were ignored. The financial crisis was not an accident. It was an accident waiting to happen.

In his book, A Colossal Failure of Common Sense, Larry McDonald, writes about how Lehman Brothers ignored executives within the firm that urged caution. McDonald was VP at Lehman in the fixed income department and he tells about a meeting in June 2005 (a year before housing prices began their slide) with Lehman's newly installed head of global fixed income, Mike Gelband. McDonald quotes Gelband as describing the domestic real estate market as "pumped up like an athlete on steroids." Despite this, the firm increased its mortgage business.

Remember, mortgages were written because they were the raw fuel that fed the securitization industry – which produced huge profits. Wall Street could not continue to produce CMOs, CDOs and all the other mortgage related derivatives without a constant flow of new mortgages. So the word went out to companies like Countrywide Financial, the country's largest subprime lender, "If you write the loan, we will buy it, no questions."

The brokers had competition for the right to buy these loans. Also feeding on this mortgage-driven frenzy were the big commercial banks. The repeal of the Glass-Steagall Act in 1999 allowed behemoths like Wells Fargo, J.P. Morgan Chase and Citigroup, to join in the insanity. Lehman and its peers (like the late Bear Stearns) had to ratchet up their leverage to stay competitive. They borrowed heavily against their balance sheets and used the funds to purchase overpriced, risky mortgages that they packaged into securities and derivatives.

Once housing prices began to fall, the banks found themselves holding billions of dollars in loans and bonds they could not sell. Commercial banks lost as much or more than investment banks, but they had the cushion of funding from depositors whose savings are guaranteed by the government. In March of 2008, it was reported that Citigroup had lost $43 billion on mortgage investments - five times more than Lehman had lost at that point. But Citigroup had $831 billion of deposits while Lehman faced nervous lenders pulling their loans and eventually went bust.

The point of useful regulation is not to create a "nanny" state. It is to impose corporate liability – a responsibility for cleaning up your own mess. In the market place, moral hazard is found when a party is freed from its legitimate obligations. During my career, I have seen the following market crashes that have costs investors dearly:

- Black Monday, October 19, 1987, the largest one-day percentage decline in recorded stock market history fueled by program trading.
- The 1997 Asian Financial Crisis which was quickly followed by the Russian Debt disaster in 1998. Long-Term Capital Management (a huge hedge fund in Greenwich) suffered $4.6 billion in losses and had to be rescued by the Federal Reserve before it could take the entire market down with it.
- The Dot-com bubble bursting in March of 2000.
- The Subprime Crisis. Dates of note - July 16, 2007 - Bear Stearns discloses that the assets of its two subprime hedge fund were worthless; leading to its failure, and September 15, 2008, Lehman Brothers files for Chapter 11 in the largest bankruptcy in U.S. history.
- May 6, 2010 – the "Flash Crash" - the Dow Jones Industrial Average dropped 900 points only to recover most of that before the close.

In none of those instances did the people or firms that may have created and profited from the asset bubbles suffer to the extent that the average investor did. The lack of consequences leads to greater speculation by subverting the balance of supply and demand. This eliminates the prime function of a free market system – apportioning risk to reward. Eventually the loss has to be taken and the market determines the proper value for the investments. This impacts only the investor, not the firm that created the product.

When the Spillway chairlift derailed at Sugarloaf over Christmas break, I couldn't help but notice the disparity between the mountain's response and Wall Street's endless denial of responsibility. Like the financial sector, the ski area has to weigh the costs and benefits of risk management. Firms like Lehman saw the risks and opted to pursue pure profit, went bankrupt and management kept every dime they had made. In contrast, Sugarloaf will have to make the capital outlay for an expensive new lift. It will fix its problems without government aid - capitalism at work. Which is one reason why chairlift accidents are very rare and financial disasters are commonplace.

IMCG NEWS

We are pleased to announce a number of additions to the firm which occurred during the last quarter of 2010. As a result of the firm's continued growth we found the need to bring three *Portfolio Manager Associates* on board as well as an additional *Client Service Associate* as a means of enhancing our research and wealth management efforts.

JOHN WARME: Joined IMCG in October having completed his MBA at the University of Maine, as well as a project as the Assistant General Manager with Pearle Vision Centers of Maine. John, a graduate of Marymount Manhattan College in New York, has also worked at Smith Barney in Portland and State Street in Boston, and currently resides in Portland.

BEN W. DAIGLE: Joined the firm in November having recently returned from his honeymoon and sabbatical. A University of Southern Maine graduate, majoring in business with a concentration in finance, Ben then spent five years as an Advisor with Ameriprise Financial gaining valuable research and planning experience. He and his wife Heather reside in Yarmouth.

CHRISTOPHER WALKER: Started with us in December after relocating from Tampa, where he worked with as an analyst with Metlife. A University of Maine graduate, where he was a marketing major, Chris worked with Unum in Boston and was an Advisor with American Express Financial Advisors in South Portland prior to his Florida experience. He and his fiancé Elizabeth reside in Scarborough and will be married in May.

We look forward to all three of these gentlemen being part of our organization where they will sit on the Investment Policy Committee and work with our other Portfolio Managers as part of the *IMCG Retirement Plan Team*.

BRYLEIGH COOK: Joining IMCG in December as well, Bryleigh is a senior communications major at the University of Southern Maine and will become a member of our *Client Development & Support Group* as she wraps up her academic endeavors and ventures out into the workplace. An accomplished three sport athlete at Gardiner High School, as well as a Dean's List student at both USM and UMO, Bryleigh also works with the Maine Red Claws organization and resides in Portland.