INVESTMENT MANAGEMENT & CONSULTING GROUP

VIEWPOINTS

1ST QUARTER 2011 — *ADVISORY NEWSLETTER*

MARKET COMMENTARY

FREDRIC W. WILLIAMS

View From the Tree House…

> *"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."* — *Mark Twain*

Hindsight always brings clarity to previously held assumptions – oftentimes in a very humbling fashion. The "technology is the new paradigm" of the late '90s and the "real estate will always go up" mantra from the mid '00s are good examples of the accuracy of Mr. Twain's observation. Too often retail investors focus on the immediate past as a means of projecting what the future will bring, becoming complacent with the comfort of what they've seen, rather than attempting to ascertain the future based on what has yet to occur. As he often does, the Oracle of Omaha put it succinctly:

> *"If past history was all there was to the game, the richest people would be librarians."* — *Warren Buffett*

As we mark the two year anniversary from the March 2009 bear market lows, it's instructive to bring a more forward looking perspective to where we are with both the markets and the economy, since there's a distinct possibility that the market's rebound may be at a more rapid rate than that of the economy. Although there's no doubt that the economy is in better shape now that it was two years ago, the condition of our housing market and the number of un- and underemployed workers seem to reflect conditions not necessarily consistent with the near doubling of the domestic indices over the last 24 months.

Indicative of this potentially new outbreak of "irrational exuberance" is a rash of trader-related media ads being blasted over the various business channels. From options, to currencies, commodities and old fashioned day-trading, a multitude of brokerage firms are pitching trading strategies – much like they were doing in the run up to the 2001 and 2007 market peaks. We're not trying to be Chicken Little-ish about the condition of the markets currently, but we struggle to see the value of day trading as a long term investment strategy when history has shown that compounding cash flow and a more measured approach to portfolio management seems to give investors more tortoise like odds when compared to the frenetic hares.

Our concern is that the outcome for the short-sighted, rearview-mirror-focused crowd could be a repeat of the recent past, leading these newly minted market mavens to lament, like the Talking Heads in their 1981 song "Once in a Lifetime", about their missing large automobile and beautiful house, and sadly concluding with the realization of it being "Same as it ever was…same as it ever was…"

For those more rational folks attempting to navigate these challenging times with a longer term investment perspective, the empirical data are showing some improvement in the economy, albeit with challenges, while opportunities still exist for those willing to look out the windshield, rather than the rearview mirror, to see what might lie ahead.

On the positive side of the ledger we had 4th quarter GDP revised up to 3.1%, from 2.8%, largely due to upward revisions in inventory and business investment. The March jobs report recently released by the Bureau of Labor Statistics showed a decent increase of 216,000 additional payrolls, with the February number also getting revised upward from 192,000 to 194,000 new jobs. The unemployment rate slipped down to 8.8% and is now down a full percentage point just since November of 2010, while the broader measure that includes underemployment, known as U-6, dropped from 15.9% to 15.7%. February disposable income eased down 0.1%, its first drop since September, and with the savings rate dropping from 6.1% to 5.8% we saw the all important consumer spending rate up 0.3% from a flat January number. As we've touched on in the past, consumer spending is a good barometer of the direction of the economy given that it represents approximately 2/3 of our domestic GDP. A pickup in consumer spending is a critical component in our recovery, while also being an excellent indicator of sentiment – seeing a pick up here might mean that consumers are feeling good enough to come out of their financial bunkers after the throes of the Great Recession.

The not so good news continues to center on the post-bubble busted housing market, where the size of this massive spheroid is being put in context by way of the continuingly abysmal data which highlights the scale of the overbuilding that inflated it in the first place. After increases the last three months, existing home sales in February were down 9.6% from January and 2.8% from February 2010. Inventories rose 3.5% to an 8.6 month level, down from 2010's record 12 month inventory level, but well above the sub-4 month level seen in early 2005 just as the pin was approaching the balloon.

New home sales were where the real carnage was as February's monthly number was down 16.9% to a record low annualized rate of 250,000 units, down 75% from the 2006-2007 peak and half of what they were in *1963*, even though we now have 120 million more people in this country. These new homes sales, or lack thereof, have an even more direct impact on the economy as they represent a significant portion of the overall construction industry's activity and employment, to say nothing of the ancillary businesses from furniture and appliances to flooring and fixtures that are being impacted by this slowdown in building.

The overall housing market is still plagued by an overcapacity problem that will likely take two to three years to organically work our way through, presuming there's not significant additions to supply from either foreclosures or (gasp!) any new building. In addition, the

Post Office Box 4802 ♦ 97A Exchange Street ♦ Portland, Maine 04112
1771 Post Road East ♦ Westport, Connecticut 06880
207.774.6552 ♦ 800.605.6552 ♦ FAX 207.775.2969
www.imcgrp.com ♦ info@imcgrp.com

broader construction industry is swallowing a bitter pill regarding its overly aggressive use of leverage that was an integral component in the real estate bubble's unique "inflation rate". As Mr. Buffett pointed out in his March 2011 letter to Berkshire Hathaway shareholders:

> *"Unquestionably, some people have become very rich through the use of borrowed money. However, that's also been a way to get very poor. When leverage works, it magnifies your gains. Your spouse thinks you're clever, and your neighbors get envious. But leverage is additive. Once having profited from its wonders, very few people retreat to more conservative practices. And as we all learned in third grade – and some relearned in 2008 – any series of positive numbers, however impressive the numbers may be, evaporates when multiplied by a single zero. History tells us that leverage all too often produces zeros, even when it's employed by very smart people."*

Working through the aftermath of the real estate bubble, which we first wrote about in this space in 2007, will take time and be a drag to growth in both jobs and our GDP. Hence our concern about the trajectory of the domestic equity indices when viewed through the relative lens of the pace of our ongoing economic recovery. Retail investors are just starting to migrate back to the equity markets – after moving to the sidelines in late 2008 and early 2009 – and could be viewed as a contrary indicator relative to market performance given their propensity to buy high and sell low. It's not that we don't feel comfortable about where the markets will go over the longer term, we just think that over the nearer term this bull may need to take a powder and catch its breath, thereby allowing the economy to play catch-up.

Although every era is different there are a couple of data points that give us comfort with regard to our continuing cash flow (dividends from stocks and interest from bonds) approach to portfolio management. One is that, according to the National Bureau of Economic Research and their data going back to the end of the second world war, the average contraction lasted 11 months while the average expansion lasted 58 months – which means we may have a ways to go in terms of an economic expansion.

Another is the recognition that what the media's talking heads refer to as the "market" may be an index that's focus isn't reflective of what a properly managed portfolio might contain. As is mentioned numerous times in the accompanying commentaries, IMCG oversees balanced (stocks, bonds, real estate & cash), globally allocated, value oriented portfolios that stress income production – a collection of attributes that may not necessarily correlate with where the S&P 500 is on a day to day basis. As noted value investor Don Yacktman put it while interviewed in the March 28th issue of Barron's when they asked him about his approach to investing:

> *"This business boils down to what you buy and what you pay for it. The market level is incidental to us…But what is staggering to me is high-quality companies still selling at below-average prices on a [price/earnings multiple] basis, relative to the market. If you buy an above-average business with a below-average price, on average you are going to come out ahead. I have to go back a minimum of 18 years to find blue-chip or high-quality companies selling at these kinds of prices relative to other things out there. It is a very unique period."*

Within this context we feel comfortable taking advantage of near term weakness to deploy additional assets within our diversified discipline, having the goal of buying into businesses whose cash flow could continue to provide us with acceptable returns even if the markets closed tomorrow and didn't open for another five years.

EQUITY MARKET OVERVIEW INVESTMENT POLICY COMMITTEE

VIX-ing It Up…

After continuing their apparently somnambulant march upward into the new year, the globe's equity markets suffered a number of rude awakenings as the first quarter unfolded. Between the political turmoil that rippled through the Arab world and the unfortunate combination of natural disasters that struck Japan, the relative calm that characterized the last half of 2010 quickly changed in the first quarter of 2011.

> *"Black swans — those unexpected market-moving events — appeared in several places at once. Upheaval in the Middle East and North Africa, Japan's devastation, and doubts about the strength of the U.S. economic recovery had shareholders mobbing the corner of Wall Street and Worry Street for several harried weeks in the first quarter."*
>
> *MarketWatch 4/1/2011*

As was seen in the VIX (a measure of volatility traded in Chicago), which drifted into the new year around 17, then jumped over 20 with the start of the Egyptian protests before spiking to around 30 with Japan's nuclear crisis, only to close the quarter back down around 17, the opening three months of 2011 were nothing like the relatively smooth ascent seen in the last half of 2010. Bur despite a roller coaster ride that saw the Dow hit a 2 ½ year high in mid-February, only to drop more than 6% by the ides of March, both the Dow and S&P 500 turned in their best first quarter since the late 1990's.

The domestic markets drifted higher in January before hitting numerous headwinds until mid-March, after which nearly all of the pullback was regained in the last two weeks of the quarter. The Dow Jones Industrial Average outpaced its domestic brethren and rallied up 6.4% in the 1st quarter, while the broader S&P 500 moved ahead 5.4%, leaving the NASDAQ in trailing position by only being able to scrape together a 4.8% advance to open the new year.

With bouts of geo-political induced fear scaring money flows toward the perceived safety of the dollar at various times during the quarter, it wasn't surprising to see that not only were the overseas markets' performances continuing to be region and situation specific, but that many of the globe's bourses actually lagged what occurred here in the 'ol U.S. of A. For a change, most of the relative drama during the start of 2011 was outside of North America, thereby keeping the majority of the disruptions away from our shores.

> *"There was no shortage of disruptions. In Japan, the March 11 earthquake and tsunami—and the still-unresolved troubles at a nuclear-power plant—continue to wreak havoc with the world's third-largest economy. In Europe, Portugal now seems almost certain to become the third country in the euro zone to require a bailout, after Greece and Ireland.*

And the Mideast—turbulent even in the best of times—now appears a cauldron of political risk that could boil over at any moment." *WSJ 4/1/2011*

Within the developed world, London's FTSE 100 was up a paltry 0.2% in the quarter, Frankfurt's DAX crept ahead 1.8%, while the Paris CAC 40 bounced back from a less that stellar 2010 and was up 4.9% to start the new year, and Tokyo's Nikkei, after dropping 8.2% in March post-the earthquake, slipped an understandable 4.6% to open 2011. The surprising story for Q1 was the discovery that most of the PIIGS could, in fact, fly as Portugal advanced 2.5%, Italy took flight with a 7.7% jump, Ireland remained grounded down 0.3%, while both Greece and Spain soared, up 8.9% and 7.3% respectively.

The developing world's stock markets, many of whom dodged the bulk of the financial crisis due in part to their reserves and trade surpluses, faced inflationary pressures that caused many central banks trying to cool their economies, resulting in more situation and location specific performance. As was seen within the BRIC complex, returns were more diverse as localized issues began to have an impact. Brazil, facing a strengthening currency in the real, imposed import tariffs and saw the Bovespa ease down 0.1% in the quarter. China, under pressure to allow its renminbi (or yuan) to float higher while still trying to control a potential real estate bubble, rebounded from a 14% drop last year to post a 4.2% advance to start the year. Russia, continuing to march to its own potentially opaque drummer, was up 6.9%, while India, after battling double digit inflation last year and a raft of continuing financial scandals, saw the Sensex decline 5.2% for the quarter

As discussed in the previous column, the key to the sustained recovery in the U.S. economy will be job growth. At the March 2011 rate of job creation, it'll be sometime in 2014 before we get back to pre-Great Recession levels, which means subdued economic growth and expectations for more modest market advances. Although constructive on the long term prospects for jobs and the post QE2 economy, we see the markets may need to bide their time a bit as the wait for the economy to catch up to the indices' rebound from the March 2009 lows. We will continue to take advantage of any weakness to accumulate income producing equities given the relative advantages of our dividend focused discipline that John details below. We remain an advocate of the tortoise like persistence of the cash flow orientation found in total return investing, which seeks out opportunities for attractive income and modest growth over time.

BOND MARKET OVERVIEW — INVESTMENT POLICY COMMITTEE

The Last Gasps of QE2…

Entering the 2nd quarter of 2011 the credit markets are beginning to see the light at the end of the tunnel – and they're not sure quite yet what to make of it. For better or worse the second round of the Fed's quantitative easing (so called QE2) will wrap up June 30th and there is no dearth of opinion as to what the impact will be on bond prices. This divergence of perspective weighed on the credit markets during the new year's opening quarter as Treasuries and munis continued to give ground, while yield-hungry demand moved investment grade and high yield debt marginally higher.

"For Treasury bonds, the second quarter will bring the last days of extraordinary support from a huge and devoted buyer, the Federal Reserve, which started a second round of quantitative easing, or QE2, in November."

"As for corporate bonds, though investors see little trouble as long as rates stay relatively low, they largely agree that the headiest days of corporates' more-than-two-year run are long past." *WSJ 4/1/2011*

The first quarter's domestic bond markets continued to be dominated by Fed influence as the F.O.M.C. continued to keep short rates firmly nailed to the floor, while their open market activity (the aforementioned QE2) worked through the $600 billion purchase commitment started in November of 2010. Buying $6 to $8 billion a day ($320 billion for the quarter), the Fed absorbed nearly all of the Treasury's Q1 2010 debt issuance in an attempt to keep longer term yields from moving higher. Despite all the firepower in the Fed's wallet, they couldn't offset market concerns as the entire Treasury yield curve, as has been prognosticated, moved higher.

The 2-year note closed the quarter yielding 0.80%, up from 0.60% at the end of December, while the 10-year note touched 3.7% in February before closing at 3.45%, up from 3.29% at the start of the year, and the "nostalgic" 30-year bond also saw its yield back up from 4.33% to 4.49% as we exited the first quarter of 2011.

The condition of state and local finances continued to roil the municipal bond market ($19.3 billion was withdrawn from muni bond funds in the quarter) pushing the yield on 10-year triple-A paper from 3.16% at the start of the year, to 3.29% at the end of the quarter, almost at parity with the comparable Treasury even before accounting for its tax free benefits.

The obviously nervous credit markets backed yields up as they debated the impact of the demise of QE2 at mid year:

"The market is split about what the end of QE2 will do to Treasury rates. One camp believes the absence of the Fed's purchases will cause rates to rise. Another believes rates might fall because the market will be less worried about the inflationary consequences of QE2. The market usually tries to think a step ahead, so either effect could show up well before the end of QE2 on June 30."

"It is also possible that the end of Fed purchases will have little net effect on Treasurys, as safe-haven demand could remain in play as the U.S. housing and labor markets continue to struggle and turmoil continues to rack the Middle East and North Africa."

WSJ 4/1/2011

Now, like it was last quarter, the rub is between the continuing attempts to keep the economy moving forward without over-stimulating it via rapid expansion in the money supply which could lead to cost-push or demand-pull inflationary pressures. We see flickers of inflation within the commodities complex (although these may be influenced by the long-only futures speculators) which can push prices higher, but we have yet to see the full-employment-bidding-up-house-prices demand that could pull prices higher. The Fed's delicate dance will be between wanting to make sure the economy doesn't fall on its face after being weaned off government life-support, and the concern that their accommodative monetary policy doesn't cause the accelerator to stick to the floor and foster unacceptable rates of inflation.

Given these concerns, we will continue to focus on keeping our maturities in the short to intermediate range, maintain a laddered structure to spread out 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.

FIDUCIARY CORNER — STEPHEN L. EDDY

Uh Oh…

Well, it finally happened: in late 2010 the first ever 401(k) excessive investment fee case that resulted in a judgment for the participant. The case, *Tibble v. Edison International*, resulted in damages awarded to the participants in the amount of $370,732. That's small change for a $3.2 billion plan, but the repercussions of the ruling are huge and will echo across the retirement plan landscape.

The ingredients for the lawsuit: one plan sponsor (Edison International, the parent company of Southern California Edison); forty mutual funds, some being higher cost retail funds with revenue sharing fees built in (12b-1, sub-TA); two advisors to the plan's investment committees that weren't named as investment fiduciaries; and one angry participant.

Note the last ingredient to the lawsuit recipe – one participant. That is all it takes to create a major public headache for the plan sponsor. This should scare every plan sponsor out there. And the advisors weren't small-office brokers either – they were consultants for Hewitt Associates and Frank Russell Trust Company, both highly respected and nationally recognized, primarily for participant recordkeeping and investment consulting respectively.

Basically, the lawsuit maintained that Edison was using higher cost retail funds when institutional share classes of the same funds were also available and that revenue sharing costs in those retail funds were negatively impacting participant balances. The excess costs due to revenue sharing were what caused Glenn Tibble to file the lawsuit. Unfortunately for the brokers and retirement plan platforms of the world, the revenue sharing system that is currently pervasive in the industry is, as Uniform Prudent Investor Act expert W. Scott Simon puts it, "*a legacy of the cost structure that needs to be in place to support a very inefficient system of gathering assets and distributing benefits in retirement plans.*" Other words he used to define revenue sharing: crazy, wholly unnecessary, circus, expensive. Not the types of terms that you want describing your plan's fee structure if you are a plan sponsor defending your role as fiduciary in a lawsuit.

The judge agreed. He found that Edison's defense of "our advisors (Hewitt, Russell) didn't tell us" was trumped by the fact that the burden is on the sponsor to ask if the investments are prudent in nature. Hewitt and Russell may have been only acting as consultants. They may have been "limited-scope" section 3(21) fiduciaries for the plan. It doesn't matter. What this case has shown is legal precedent for two things:

1. Absent a Section 3(38) Investment Fiduciary specifically contracted by the plan sponsor to evaluate and monitor the investments, the burden is wholly on the plan sponsor to make the proper choices. Furthermore, the "limited scope" 3(21) co-fiduciary designation that many brokers use as a way to say "we're right there with you" offers no protection.
2. In the court's opinion (and IMCG's as well, I might add) less expensive institutional share class funds are preferable as options versus more expensive revenue sharing funds. *Until the 408(b)(2) fee disclosure rules are fully implemented (pushed back until 2012), there is no requirement for plan advisors to disclose such revenue sharing.*

Of course as one commentator put it, this being the United States, naturally both sides have appealed the ruling – Edison (large company defendant) wants it overturned, Tibble (angry participant plaintiff) wants more money.

If you are a plan sponsor and you are not working with a full scope section 3(38) Investment Fiduciary (virtually no insurance or stock brokers will sign as one), or if you don't know if your funds are making revenue sharing payments, you should be concerned by this ruling. At IMCG, signing on in writing as your section 3(38) Investment Fiduciary, reducing your plans expenses, reducing your fiduciary liability and improving your fund menu's performance are our primary concerns.

An Example of the Differences Between Share Classes

The American Funds AMCAP Fund has multiple "retail" share options - classes that have embedded 12b-1 revenue sharing fees (A, R1, R2, R3, R4) - and two "institutional" share classes (R5, R6) with no embedded revenue sharing fees. *Note that all of these share classes hold identical investments in their portfolios*. The only difference between the share classes is fees/revenue sharing paid from the fund, either to the brokers as compensation or to the platforms to reduce expenses. The table below represents the 2010 calendar year one year returns for the different share classes of the fund.

AMCAP Fund Share Class	12b-1 Fee (Revenue Sharing)	1 Year Return 12/31/10
A	.25%	13.98
R1	1.00%	13.14
R2	.75%	13.02
R3	.50%	13.60
R4	.25%	13.92
R5	.00%	14.29
R6	.00%	14.33

The share class used in your plan is up to your plan's advisor. As you can see from the table, depending on the share class (or another way to say it – "depending on the revenue sharing fee"), the return for the AMCAP Fund ranges from 14.33 to 13.02. The 12b-1 fee makes up a large portion of the return differential, but also be aware that there are other, even less commonly disclosed, methods of revenue sharing which make up for the subtle return differences that can't be explained by the 12b-1 revenue sharing fee alone.

WEALTH MANAGEMENT UPDATE TRACY W. ROGERS

Editor's note: With Tracy preparing for a series of client meetings in Colorado his article on cost inflation concerns we all will face in retirement has been moved to the 2nd quarter issue of VIEWPOINTS. In his stead he has our three new Associates providing some commentary below.

PLANNING CONCEPTS

Show Me…the Dividends… ***John Warme***

At IMCG our dividend and value based, highly diversified, global investment strategy has been unwavering since we established the firm in 1994. It's not sexy; it's not exciting; but the truth of the matter is that it works. Similar to the rash of articles and experts in 2010 touting the fiduciary standard for retirement plans as the wave of the future – a concept IMCG has applied to our clients' retirement plans from the start - we are now seeing article after article related to the benefits of dividend paying stocks. Once again, a style of investing we have been practicing since our inception.

Many recent studies have pointed out what we have known for years, namely the fundamental value approach with a focus on dividend-yielding stocks is in fact a way to boost total portfolio return, and not just to produce an income stream.

The concept seems counter-intuitive. How can securities which pay you money to own them (dividends) and are typically insulated from wild swings in relation to the market also prove to be the best market performers as well? One answer lies in the concept that instead of high dividends representing a corporate board's realization that they are at the end of the company's growth curve, as many think, it is in fact a signal of the board being so confident about future cash flows that it is passing those flows on to the corporation's owners, its stockholders. When those higher future cash flows are realized, the share price is destined to appreciate.

According to data provided by McCarthy and Bergagnini of Oppenheimer, S&P 500 stocks that increased their dividends over the period 1973 through 2010 had the following record of outperformance when compared to their peers over the same time period:

PEER STOCK CATEGORY DIVIDEND BEHAVIOR	BEST WORD/PHRASE TO DESCRIBE CATEGORY	INCREASING DIVIDEND COS. OUTPERFORMED BY
DECREASED DIVIDENDS	TROUBLED	10.08%
STAGNANT DIVIDENDS	TROUBLED GROWTH	2.16%
ZERO DIVIDENDS	GROWTH	7.50%

Once again, the tortoise beats the hare.

The case for dividend-yielding stocks is made strongly in a study by C. Thomas Howard, PhD, *The Power of Dividends*, published January 25, 2011. We would be more than happy to provide a copy of this study to anyone who would like to read more evidence supporting our investment style. Give us a call or drop us an email and we'll get it out to you.

Notable Improvements in 529 Plan Offerings — *Ben W. Daigle*

Whether you are currently saving for your child's future college education or you are a recent parent that hasn't even thought that far ahead, a 529 college savings plan review is in order, as there have been some interesting new trends among the many 529 plan offerings.

<u>Brief Overview</u>: a 529 plan allows you to invest money for a family member that can be later withdrawn tax free to pay for almost any accredited college, community college or vocational school. The 529 plan is funded with after tax money and grows tax-free if used to pay for post-secondary education items, including room and board, tuition, and textbooks (although last year the ability to pay for computers and internet fees was repealed and no longer counts as a qualified distribution). For 2011, the maximum a single individual can gift into a 529 plan for any one beneficiary is $13,000.

You can choose to invest in any 529 plan you want from the many state-sponsored choices around the country. When comparing 529 plans, the major factors to consider are plan costs and fees, quality of the investment choices, and tax-benefits within your home state. With regard to fees, many plans have been reducing their fees to attract new contributions and thus making them more appealing to investors. Some of these plans have also been looking to expand the types of investment choices offered, including index mutual funds and FDIC insured savings accounts. And lastly, it is important to remember that the benefits of reduced fees and improved investment choice may take a back seat to the tax benefits you may receive from selecting the plan offered by your state of residence.

<u>The Study</u>: Towards the end of 2010, Morningstar completed a review of the 52 largest 529 plans and ranked them based on performance, price, management team, stewardship practices, and underlying investment quality. In 2010, five plans achieved ranking in the top category:

- Two direct sold plans from T. Rowe Price received top honors: the Alaska-based T. Rowe Price College Savings plan and the Maryland-based College Investment plan were both recognized for their long term asset managers and consistent performance. These are two of the few direct-sold plans that emphasize actively managed funds rather than index funds.
- The Vanguard 529 College Savings plan in Nevada and Ohio's College Advantage 529 savings plan received high marks for having fairly low fees while still offering a good variety of investment choices. The Vanguard plan recently cut their fees to .25% on their age-based portfolios to become the low-cost leader in the indexing strategy category, while the Ohio plan specifically mixes sought-after money managers from a number of firms. Usually this would result in higher fees for the investor but the plan's management team has held them to some of the lowest for their respective strategies.

- Lastly, College America, the largest of all 529 plans which offers exclusively American Funds, scored consistently well across all categories.

There have been significant improvements in the 529 plan offerings. The industry seems to finally be listening to the consumers and providing a quality product for a decent price. As more money flows back into the 529 plans we should continue to see competition create better choices and lower fees. If you would like to learn more about the available 529 plans and other education savings tools or complete a review of your current education plan, please call us at IMCG to schedule a meeting.

1035 Exchange - Is It Appropriate For You? ***Chris Walker***

What is it?

Under Section 1035 of the Internal Revenue Code, the owner of a life insurance, endowment or annuity contract is allowed, under certain circumstances, to exchange their contract for similar or related types of contracts from different companies without the recognition of any unrealized gains, which may have accrued in the original contract that is being exchanged.

There are some stipulations as to what can be considered a tax-free exchange under IRC 1035. The code applies only to the following exchanges:

1) A life insurance contract being exchanged for another life insurance, endowment or annuity contract.
2) An endowment contract for another endowment or annuity contract.
3) An annuity contract for another annuity contract.

An exchange going from an annuity contract to a life insurance contract is not allowed. In addition, the owner and insured, or annuitant, on the new contract must be the same as on the old contract.

Why would a 1035 exchange be advantageous for our clients?

A 1035 exchange may allow the contract owner the opportunity to exchange outdated contracts for more current and efficient contracts, while preserving the original policy's tax basis and deferring recognition of gain for federal income tax purposes.

Two examples of when the 1035 Exchange makes sense

1. You originally purchased an annuity by funding it with a $50,000.00 deposit.
    - The annuity has grown to have a cash value of $80,000.00.
    - You don't like the high fees you are paying and want to switch products.
    - Rather than surrender the old contract and cause a taxable event, you could "1035" the annuity to a new annuity with lower fees, more investment options and better overall flexibility. This defers taxes on all of the $30,000 gain.

2. You have originally funded a life insurance contract with $70,000.00.

- The value has now decreased to $40,000.00.
- You could "1035" the original life contract for a new annuity contract and the cost basis on the new annuity would be at $70,000.00. This means that the first $30,000 of growth in the annuity would be income tax-free.

A 1035 exchange may not be appropriate for all situations and there are many things to consider such as surrender charges with new annuities and insurability on new life insurance contracts but it may also be a very wise decision for your future and the future of your portfolio.

INSIDE THE MARKETS FRANCIS J. DAVIES III

The Golden Bubble

"The desire for gold is the most universal and deeply rooted commercial instinct of the human race." *Gerald M. Loeb*

Diversification

One school of thought on investing holds that it is better to put all one's eggs into one basket and then watch that basket like a hawk. A better idea is that it is wiser to spread investments in a portfolio among several different baskets or to *diversify*. This is the approach we employ at IMCG. The reason is simple: it greatly reduces the risk of the portfolio. It may increase the possibility of losing one egg, but it eliminates the possibility of catastrophic loss from an unforeseeable, market-wrenching shock.

The way we gauge the effectiveness of the diversification is to look at the *covariance* of the various holdings in the portfolio. Covariance measures whether a group of holdings react similarly or inversely under changing market conditions. Increasing covariance produces a portfolio in which the component investments do not move up and down in lockstep. Done properly, diversification produces a portfolio with a combined risk profile that is lower than that of its least risky holding.

We weigh many risk factors when selecting our holdings. We seek to diversify currency risk by holding non-dollar-denominated instruments; inflation risk through commodity-based holdings and inflation indexed bonds and economic risk by allocating amongst fixed income, equity and cash. Within the equities, we reduce risk by owning shares in companies from different industries, from various size concerns, both growth and value stocks, based in different countries.

One area where we have not had a large exposure is precious metals. Gold is a very popular investment these days and has had terrific returns over the past few years. As explained above, investment selection is not based solely on potential for return. The process also takes into consideration the specific risk the investment should offset. Gold is thought to be a hedge against inflation, currency weakness and economic disaster.

The Fundamentals - Valuing the Metal

Gold closed out the first quarter at $1430 per ounce. It is essentially flat for 2011 YTD. That is the price; finding the underlying basis for it is not as easy as valuing a stock. The inputs used to value stocks and bonds are straightforward and have remained largely unchanged since Benjamin Graham published <u>Security Analysis</u> in 1934. The quantifiable influences on a stock's value include factors like the interest rate environment, the prevailing inflation rate as well as company specific data such as earnings, barriers to competition and dividends. One less easily defined input is market and investor sentiment.

In the case of gold, a quick look at a historical price chart gives the impression that sentiment is the *primary* driver. The price is divorced from fundamentals such as industrial use, narrowing supply or central bank actions (by adding to reserves).

While it is a fact that the value of fiat currencies has been greatly diluted by the enormous increase of currency in circulation; a look at a chart of the purchasing power of a US dollar shows that dollar weakness is hardly a recent development. There was an enormous decline in the value of the greenback during the period between 1900 and 1920, when the Roaring Twenties kicked off. The dollar dropped again after the Bretton Woods agreements were dissolved in 1971 by President Nixon, removing the dollar/gold connection. The decline continued steadily until the early 1980's. Since then, the downward trend is more of a drift than a plummet.

Dollar strength

The recent spike in gold exaggerates the loss in purchasing power experienced by the US dollar. It also is not connected to actual inflation. To hedge against inflation, we prefer inflation-indexed bonds rather than gold. The bonds produce some income while providing inflation protection. Gold does not provide an income stream and it entails storage costs. If inflation finally shows up and interest rates climb, these higher yields only increase the opportunity costs of holding gold.

We hedge our dollar positions by investing abroad again seeking income as well as growth. The US dollar has been sailing into a stiff headwind for a number of years. Quantitative easing by the Fed has flooded the market with dollars and the US budget deficit will surpass $1 trillion for the third year in a row in 2011. Despite this, the dollar has remained steady against most major currencies in the past 52 weeks. It has held its ground vs. the British pound, the Canadian dollar and the Euro.

One of the best rules I learned in my years working on a stock trading desk is that when a stock no longer drops in price after bad news is released, it merits further research. The lack of selling indicates that it could be sold out; that there are no sellers left with *supply*. The inverse is seen when a stock does not react positively to good news. In this case, everyone who wants to buy has already bought and there are no new purchasers - no sources of *demand* - out there.

The market is looking to the positive factors for the dollar. A budget deficit reduction will happen at some point this year. The Euro zone faces debt problems worse than our own, particularly in Spain and Portugal. Despite fears to the contrary, the dollar remains the global currency of choice for institutional investors who remain very reluctant to abandon a dollar-denominated currency reserve system. The domestic economy continues to show signs of life. US companies have pared back costs, hold huge cash positions ($2 trillion at last count) and stand to benefit greatly from a global recovery. Earnings growth in largely dollar-denominated investments will increase demand for the dollar.

The ETF Factor

Demand for gold comes from three main sources. Industrial uses account for 10% and jewelry about 40%. The other 50% of demand is for investment. Demand from the first two dropped 4% in the period from June 30, 2009 to June 30, 2010, while investment demand rose 118%. Much of this came from a single source; the SPDR Gold Trust ETF (exchange traded fund) which was launched in November of 2004.

This trust issues shares that are said to be backed by gold, although the fine print in the prospectus outlines how difficult it would be for a shareholder to take physical delivery of the underlying gold. From June 30, 2009 to June 30, 2010, demand for gold from this one investment rose over 400%. However, the first quarter of 2011 saw the amount held by the trust drop 5.4%, from 1280.72 tons to 1211.23. These holdings equal ½ of annual mine supply and are worth $55 billion. This huge locked-up position has drained the market of natural sellers. It is not reassuring to have this percentage of supply held by speculators that will run for the exits when the price corrects.

The same ETF effect has been seen in oil prices. In his new book, Oil's Endless Bid, Dan Dicker details why oil at $100 a barrel has precious little to do with supply, demand, or Libya and much to do with speculators *perceiving* a supply problem. Commodity markets were designed for investors with a genuine interest in the underlying commodity could hedge their livelihood. Oil futures were meant to be traded by airlines, heating oil suppliers and the like. When the capital markets froze in 2008, speculators in all markets ran for the sidelines and the value of a barrel of oil was revealed to be $32.

Commodity exchanges that are dominated by speculative investors are hauntingly familiar to the trading in credit default swaps which bankrupted AIG and helped bring about the economic collapse of 2008. The ease afforded by electronic trading of futures has exploded the volume at commodity exchanges. The gold market has become one-sided without natural sellers. Several commodity future markets are dominated by just a few enormous firms easily capable of manipulating prices.

One flagrant example of this is the trading in silver futures. A class action suit filed against JPMorgan Chase and HSBC claims that at one point, those two firms controlled 85% of the commercial net short in the silver futures contracts at the COMEX. Their short position meant they were betting against silver and used their combined might to suppress the price of silver. In order to adhere to the oft-maligned Dodd-Frank regulations, these positions should not exceed 10%. To get around these limits, commodity regulators have granted waivers to the large players.

Conclusion

Gold is a form of commodity and its price is subject to major fluctuations. Part of the price reflects economic uncertainty. But it has another, more primal appeal. The earliest metallic forms of money were gold and silver. The metals had no use value, but they did have display value. It is a value that Karl Marx termed commodity fetishism, “value set not by usefulness but by its ability to be exchanged for other items.” Such is part of the appeal of gold jewelry, which could be seen as the most discretionary of all discretionary purchases.

This primal instinct is targeted by the commentators jumping on the economic Armageddon bandwagon, claiming that gold is the only investment that will protect you when the economy craters. One makes a very specific recommendation; he tells listeners to buy collectors’ coins from Goldline, an online dealer. These supposedly “rare” coins have a typical mark-up of at least 30% over the value of the bullion which does not make them particularly safe investments. But the question remains, will those coins or bullion or Golden Eagles be the last standard of value left in a world dissolved into chaos? The belief in the ultimate value of gold is being tested today in a very public forum.

Libyan leader Muammer Gaddafi was convinced that gold would prove its worth in an emergency and stocked away huge amounts in preparation for the worst case scenario.
Bombs rain down on his kingdom, his overseas assets are frozen and key officials from his government are seeking amnesty abroad. Control of his empire and its armies is slipping out of his hands as his subjects seek to overthrow him. He is definitely facing the possibility of end times and it is time to put his gold to use.

Muammer is sitting on a substantial pile of gold. There is reportedly 143 tons of it in his personal piggybank - the Libyan central bank. Those reserves, among the top 25 in the world, are worth more than $6.5 billion at current prices, enough to pay his mercenaries for years. And, unlike most national banks, the Libyan gold is not stored in New York or Switzerland, it is in country. But it has proven worthless so far.

Gaddafi’s gold cannot feed his troops, be fired at his enemies nor fuel his jets. The flip side is since gold has no actual physical use; it is not destroyed like ammo or consumed like food. Still, he needs to exchange it for something useful. As David Cohen, the new acting undersecretary for terrorism and financial intelligence at Treasury, put it, "He, I suppose, could, you know, chip off pieces of his gold bars to pay his mercenaries, but more realistically what he'd like to be able to do is convert those gold reserves into hard currency." Currency could pay his troops, buy munitions and bribe the enemy.

Exchanging the gold is proving to be difficult. “If a country like Libya wants to make their gold liquid it would probably be in the form of a swap – whether for arms, food or cash,” said Walter de Wet, head of commodities research at Standard Bank. No international bank or trading house is likely to buy gold with any hint of a link to the Libyan regime, at least not openly.

Under chaotic conditions like those predicted by the economic Armageddon crowd, piles of the shiny metal have not rescued Gadaffi. His example demonstrates the value of gold is strictly the ability to convert to something else. There is no inherent value in the gold itself. While the average investor may not face Libya's problems when converting gold to cash, he would still have to find a buyer. In the midst of the end times depicted by fear-mongering media, a time when people will be burning Picassos and Pollocks for heat, who will be willing to accept shiny yellow metal in exchange for critical items like food, fuel, protection or shelter?

Gold remains a solid, speculative holding, but not one that fits into our discipline of value and income.

IMCG NEWS

***FRED WILLIAMS* –** While meeting with clients on the east coast, Mr. Williams attended the Morningstar Ibbotson Conference in Orlando in early March. This analyst's symposium continues Ibbotson's tradition of bringing academic theory to industry practice, with thought leadership on asset allocation, investment research, economic analysis and portfolio strategy. This year's gathering featured presentations by founder Roger Ibbotson, who unveiled a study on the impact that low liquidity stocks can have on enhancing investment performance, respected value investor John Rogers of Ariel Funds who spoke about the advantages of total return investing (his firm's logo includes a tortoise) and Professor Karl Case, co-founder of the Case-Shiller index, who detailed his outlook on the housing market and its continued impact on our economy.

***STEVE EDDY* –** Was recently asked to join the board of the University of Southern Maine Athletic Development Council, which supports and coordinates the fundraising activities of the various USM athletic programs.

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:

> ***18th Annual Chef's Gala* –** Dinner, by a variety of local chefs with a "Classic Hollywood Night" theme, and dancing to benefit Maine Coast Memorial Hospital's Breast Clinic. To be held April 30th, 5:30 P.M. to midnight, at the Ramada in Ellsworth, Maine. Additional information and tickets can be found at www.mcmhospital.org.

8th Annual Camp Ketcha Golf Tournament – To benefit the Camp's programming, youth development and community support services, this event is scheduled for June 14th at the Prout's Neck Country Club – registration begins at 10:00 AM. Additional information can be found at http://campketcha.com.

18th Annual Child's Play Golf Benefit – The Dream Factory of Maine's annual event to raise funds for its mission of granting dreams to the critically and chronically ill children of Maine. Scheduled for Friday June 3rd at Sable Oaks and starting at noon, The Dream Factory grants dreams for critically and chronically ill children nationwide, is based in Louisville, and has 2 chapters in Maine. Additional information can be found at www.dreamfactoryincmep.org.

Fore The Kids Golf Classic – Big Brothers Big Sisters of Southern Maine's annual fundraiser will be held June 20th at The Woodlands Club. Additional information on this popular two-ball/best-ball event can be found at www.SoMeBigs.org.

Greg Francoeur Memorial Golf Tournament – The 8th 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 22nd at the Val Halla Golf Course in Cumberland, Maine.