INVESTMENT MANAGEMENT & CONSULTING GROUP

VIEWPOINTS

4TH QUARTER 2011 | ADVISORY NEWSLETTER

MARKET COMMENTARY

FREDRIC W. WILLIAMS

Stop Playing With the Light Switch…

Bidding adieu to 2011 feels therapeutic (yes, perhaps even cathartic) on a whole variety of fronts, not the least of which has been opportunity to say adios to the propensity for "risk on-risk off" market swings over the last twelve months as manic investors have had herd-like reactions to the multitude of media headlines and potential policy-maker (in)decisions.

Illustrative of the level of these gyrations was the fact that there were 35 times where the S&P 500 closed up or down 2% or more last year, up from 22 in 2010 and a far cry from the "old days" where we saw no swings of that magnitude in 2005 and only 2 in 2006. There were more than 100 days that the Dow had 100-plus-point swings between open and close during 2011 – more than one third of the year's trading days. The highlight of last year's roller coaster ride was the post-Congressional debt ceiling debate debacle in early August that was the catalyst for S&P's U.S. credit rating downgrade, and which was then followed by 4 straight days of 400+ point swings in the Dow.

After enduring the often labeled "Lost Decade" for domestic equity performance, investor's moods were further soured by last year's volatility as it drained them emotionally while not enriching them financially. Compounding this cynicism was the macro-drama playing out around the world that continued to taint the general public's view of politicians, policy makers and the financial wizards who brought us the "Great Recession" that was taking its sweet time leaving our rear view mirror.

> *"Talk about a bumpy ride. If you invested money, wanted money, or simply had money, 2011 was the Year of Living Dangerously.*
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> *"We had downgrades and Wall Street Occupations, sovereign crises that led to abdications of fiscal sovereignty (come on down, Italy and Spain) and "voluntary haircuts" that no investor wanted. We had rogue traders, insider traders and really awful traders (yes, you Jon S. Corzine). New words entered the financial jargon, ranging from the tongue-twisting—try saying EFSF 10 times quickly—to the vaguely insulting—Piigs, Giips—to the Mary Shelley-esque (what does a Merkozy look like?).*
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> *"Markets were buffeted by all of this, and a lot more. For much of the year, investors were dazed and confused by a cacophony of news, rumors and wishful thinking."*
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> *F. Guerrera, WSJ 12/27/2011*

As the year wore on Occupy Wall Street in New York and Occupy The City in London were emblematic of the public's disdain for, and distrust of, the globe's financial markets, systems and players – in many cases for some perfectly justifiable, although often over-generalized, reasons.

In somewhat of a prescient commentary in 2005, Stieg Larsson's financial journalist character Mikael Blomkvist in "The Girl With The Dragon Tattoo" made the following observation about the disconnect between market movements and the condition of the underlying economy:

> *"You have to distinguish between two things – the Swedish economy and the Swedish stock market. The Swedish economy is the sum of all the goods and services that are produced in this country every day. There are telephones from Ericsson, cars from Volvo, chickens from Scan and shipments from Kiruna to Skovde. That's the Swedish economy, and it's just as strong or weak today as it was a week ago."*
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> *"The Stock Exchange is something very different. There is no economy and no production of goods and services. There are only fantasies in which people from one hour to the next decide that this or that company is worth so many billions, more or less. It doesn't have a thing to do with reality or with the Swedish economy."*

From a practical standpoint, these perspectives, both actual and fictional, were epitomized in the real world via the fund flows data that was recently released by Morningstar. Using retail mutual fund deposits and withdrawals as a proxy for investor sentiment we can see just how shunned the equity asset class has been over the last several years. Normal annual stock fund flows are net positive as investors and retirement plan participants add to their savings on a regular basis, maintaining a longer term time horizon and adhering to a dollar cost averaging discipline to take advantage of, rather than run from, market volatility.

In 2008 as the financial crisis was unfolding, net outflows were approximately $89 billion from domestic equity funds. In 2009, when the markets hit the March low and then doubled in the next 2 years, net withdrawals were still $24 billion for the year. Somewhat surprisingly, 2010 saw $75 billion in net outflows, while 2011's numbers show that an additional $77.1 billion was once again pulled from the stock market. Given that the benefactors of these withdrawals were low-yielding bond funds and cash, it's fairly easy to conclude that individual investors have very low expectations for equities going forward.

Years of market history has shown that investor sentiment tends to be a contrarian indicator: extreme bullishness often presages market declines, while extreme pessimism often heralds a market upturn. As skeptically healthy contrarians (thereby being able to hedge our perspective from all angles) we find this level of pessimism to be a positive component of our expectations looking forward. Those of us of a certain age can easily recall the 1979 edition of Business Week that proclaimed "The Death of Equities" after the bear market, oil shocks and inflation of the 70's – a magazine cover that turned out to be the uber-contrarian indicator of the last half of the 20th century.

In addition, as noted in this space last issue, there is an, albeit modest, improving economic landscape that could be supportive of equity prices in the future. With corporate balance sheets buttressed from two years of corporate profits piling up in cash, and equity valuations relatively attractive, it would appear that any constructive surprises for domestic GDP growth, and/or progress in a sustainable euro-zone recapitalization, could provide the traction for markets to advance.

The last piece of this more positive puzzle might be a "theory of relativity" from a financial standpoint as we evaluate the options in front of us as savers or investors going forward:

> *"Investors riveted by the market's ups and downs can lose sight of the fact that stocks are pieces of real businesses. These companies sell real products and services, and produce real profits from which real dividends are paid. The anxiety that has gripped the market has created valuations well below average, so those real profits can be obtained cheaply, and the dividend yields are hefty, especially compared to what's available in bonds.*
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> *"No matter how much they dislike stocks, whatever the price, young people will still have to retire one day and meet other financial goals. They can't do that earning 1% or so at the bank.*
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> *"With or without these buyers, stocks can still go up. This is not the first time that the market has been out of favor. Stock ownership was not as prevalent a century ago as it is now, but the mania that led to the crash of 1929 and the Great Depression were sufficiently significant social phenomena to keep small investors away from Wall Street for decades. Even so, share prices advanced fairly relentlessly."*
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> *- C. de Aenlle, MarketWatch 1/1/2012*

This is not to say that we're viewing the near term with rose colored glasses, but it's more the perception that against an incrementally positive macro backdrop the likelihood of a mean reversion to the upside is becoming an increasingly possible outcome over the intermediate-to-longer term. With sentiment as down in the mouth as it currently is we sense an attractive risk-reward dynamic, and steadfastly will stick to our closing comments from last quarter:

> *"This is not to suggest that we see nothing but clear sailing ahead as it will take an inordinately long time to gradually work through the housing and debt challenges that will still present headwinds to more robust growth. But what we don't believe is that the world is going to come to an end (at least not this month) and as such we think this quarter's fear-induced sell off in the equity markets is an opportunity to acquire shares in durable businesses at compelling valuations that are providing significant cash flow from dividends."*

Perhaps 2012's New Years' resolutions should include switching from CNBC to the Food Channel, stopping the hourly intraday market updates that are being sent to your Smartphone, downloading an actual book to your tablet when you go on vacation and turning off the volume when you start to see politicians on TV during the rut of another election cycle.

EQUITY MARKET OVERVIEW — INVESTMENT POLICY COMMITTEE

Back From the Door to the Bear Den…

After a nearly 20% decline from the late April highs to the early October lows, which left Wall Street with a waft of ursa-like odor in the air, the domestic equity markets rallied in the 4th quarter of 2011 as the mid-year "risk off" fear trade grudgingly gave way to kernels of positive economic data, as well as glimmers of hope that political ideologues on both sides of the Atlantic were actually moving toward more pragmatic policy decisions.

From a reduction in jobless claims and unemployment (both the lowest since March of 2009) and a pick up in the housing market (both new and existing sales), to an improvement in consumer confidence and holiday spending, fears that the U.S. economy would relapse into another recession appeared to have abated.

Overseas the focus was still Euro-centric as all eyes were on any "Merkozy" (German Chancellor Merkel and French President Sarkozy) comments, as well as the ECB and IMF dialogue with pan-European central bankers. As noted below in the bond market overview, the year's frustratingly halting discussions centered on resolving the sovereign debt challenges turned more positive in late December, thereby diminishing an element of worry for equity investors.

The domestic stock market saw these dynamics as supportive of share prices, while the rest of the globe didn't fare nearly as well. At the conclusion of 2011 the most that could be said was that the U.S. markets looked like the best house in a bad neighborhood. In addition, all the year's volatility frayed the nerves of longer term investors [a camp we resolutely choose to find ourselves in], some of whom fled to the safety of bonds and cash as the bulls and the bears battled to a virtual stalemate.

> *In standing still, the market spent the year doing the financial equivalent of a driver "feathering the clutch" in a car sitting midway up a steep incline: The direction of nature's pull was lower, but just enough force on the gas pedal now and then, with the exact right simultaneous pressure on the clutch, halted the backsliding and kept things steady, if precariously so.*
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> *The force of gravity, in this instance, was the macro/Euro/credit drama, constantly keeping investors on alert for some force majeure declaration that the financial system itself—banks, currencies, international trade arrangements—was again in peril. The fuel opposing it was corporate business conditions, with rising profits and plenty of cash on companies' books.*
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> *Part, but not nearly all, of last year's erratic daily pattern can be explained by the flight of patient capital from equities, leaving the field to the short-term scalpers and incentive-fee mercenaries who must trade to survive.* *- M. Santolli, Barron's 1/2/2012*

Domestically the numbers were fairly dispersed as the Dow Jones Industrial Average reversed course and rallied 11.2% in the 4th quarter, up 5.5% for 2011, and the broader S&P 500 was up almost 10% to close the year essentially flat, off 0.003%, while the NASDAQ was only up 2.9% in the quarter and declined 6.1% for the year. The rock star in the domestic indices arena was once the Dow Utilities Average, up another 7.7% in the quarter and a stellar 14.7% over the last twelve months…suggesting that the flight to dividend paying equities had caused the tortoise to sneak in a little more training time on the treadmill than the snoozing hare recognized.

Continuing euro-zone challenges took more of a toll on other developed world bourses, with London's FTSE 100 up 7.6% in the quarter, but still off 5.6% for the year, Frankfurt's DAX rallied 5.7%, although still closing down 14.7% in 2011, while the Paris CAC 40 moved ahead 4.6%, but declined 17%, for the quarter and year respectively. Adding further to Japan's woes in 2011, Tokyo's Nikkei suffered as the Asian region sold off on fears that their export oriented economies would be hurt by the challenges in Europe, dropping 2.3% for the quarter, and leaving it down 17.3% for the year.

The Asian headwinds also hit the broader developing world as a concern about an absence in import demand for their products pulled investor funds indiscriminately from the overall emerging markets asset class. Once again using the BRIC complex as a proxy for the developing markets, Brazil, despite relatively strong economic growth, saw the Bovespa recover 6.4% in the quarter, still leaving it down 18.1% for the year. China, facing a series of corporate accounting scandals, dropped 5.7% in the quarter, finishing off 21.7%, while Russia added 5.7%, closing down 20% for the year, and India eased an additional 4.8% on inflationary concerns, off 24.6% for 2011.

Europe's sovereign debt issues, as well as the politics of policy making at home and overseas, will continue to keep near term equity performance hostage in early 2012. In conjunction with the aforementioned capital markets volatility, relatively low stock market valuations will present opportunities for patient investors to add to dividend paying domestic and multinational companies, all within the context of the longer term macro story where we expect growth in the emerging markets to be greater than in the developed world as a result of a younger population and an expanding middle class.

BOND MARKET OVERVIEW — INVESTMENT POLICY COMMITTEE

Operation Twist(ed)…

Serving as both the acronym for the Fed's most recent version of faux-quantitative easing, as well as a potential description of European policy makers of late, "twist(ed)" seems an apt label for the focus of the credit markets on both sides of the Atlantic during the 4th quarter of 2011.

Stateside, Operation Twist was wrapped up December 28th, far earlier than the originally announced June 2012 end date, with the last sale of short dated (3 – 6 years) paper being used to fund the Fed's purchases of longer dated government bonds in an attempt to keep interest rates low. Although, as seen below, Treasury yields came down modestly during the quarter, there was a more significant impact on residential mortgage rates, spurring another round of real estate refinancings with the national average 30-year fixed closing the quarter below 3.95% and the 5/1-year AMR coming in under 2.9%, according to Bankrate.com. Corporate borrowers also benefited as for the 3rd year in a row corporate bond sales exceeded $3 trillion – with $3.17 trillion in 2011, following on the heels of $3.2 trillion in 2010 and $3.91 trillion in 2009. All of which allayed fears that the credit freeze of late 2008/early 2009 would be repeated, thereby potentially causing another liquidity driven recession. With both home owners and corporations taking advantage of low rates to save on interest costs, and as a result positively impact their cash flow, glimmers of support for an albeit modest recovery continued to emerge as we closed out the year.

In the Euro-zone the histrionics moved from Greece to Italy as the political drama surrounding Berlusconi's parliamentary coalition collapsed under the combined weight of Italy's sovereign debt load, as well as Mr. Berlusconi's personal proclivities. Unlike the relatively small size of the Greek and Portuguese credit markets, Italy has the 3rd largest bond market in the world (behind the United States and Japan) so tremors there could have far reaching impacts elsewhere. After piercing the critical 7% level on the 10-year bond in November, a "coordinated" series of central bank interventions halted the rise in Italian debt yields into December, and then (finally) a tentative plan came together just before the Christmas holiday.

Ideologues had argued since the inception of the euro-crisis about the role of the European Central Bank and whether it should function as the lender of last resort, just as the Federal Reserve had done domestically. Then the ECB granted about $630 billion in 3-year loans to banks across Europe as well as loosened collateral requirements for future loans, all under the auspices of what's being called the "Long Term Repo Operation".

> *"Despite widespread skepticism over the efficacy of the measure, the LTRO seems to be a far more powerful signal to the markets than many suspect. It signals a willingness by the ECB to print euros and provide liquidity to the European banking system in any quantity desired. And it stands at least an even chance to head off the contagion, triggered by Greece's debt woes, that has threatened the solvency of euro-zone countries as diverse as Portugal and Ireland in addition to Italy and Spain. In a world in which a liquidity crisis can quickly morph into contagion, the LTRO could prove crucial.*
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> *"This facility could help solve a number of seemingly intractable problems. By being able to borrow unlimited amounts of money at the current ECB interest rate of 1.0%, European banks will have access to cheap money to replace fleeing deposits, costly bond funding and a frozen interbank lending market. The ECB hopes, of course, that the funds will be used to buy the high-yielding, sovereign debt of the likes of Spain and Italy for collateral and bring down their punishing and untenable debt funding costs."*
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> *- J. Laing, Barron's 1/2/2012*

Although Treasury yields crept down modestly in Q4, the last half of 2011 will be remembered for the "risk off-fright flight" trade that drove assets from around the globe into U.S. government bonds, producing equity like returns. Fed pronouncements about keeping rates low through 2013 continued flatten the yield curve as the 2-year note closed out Q4 yielding 0.24%, down from 0.248% at the end of September and .80% at the end of 2010. The 10-year note traded to 1.885%, down from 1.929% at the start of the quarter and 3.3% at the beginning of the year (producing a total return of 17% in 2011), while the 30-year bond saw its yield drift lower to 2.899% from 2.921% and 4.49% respectively, generating a 35% return for the year.

Our perspective on the credit markets going forward, as noted in this space last quarter, has not changed:

> *"With yields now plumbing historic lows given concerns about a global economic slowdown, we're focusing on the horizon and see the likelihood of higher rates down the road as the world eventually recovers from the Great Recession. As such, we will continue to keep 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."*

A "Public Service" Announcement…

> *You can't always get what you want, but if you try, sometimes you might find you get what you need…*
>
> Mick Jagger/Keith Richards

In last quarter's newsletter, I reviewed the new fee disclosure regulations and upcoming impact they are likely to have on the retirement plan marketplace. As discussed in that column, many plan sponsors will be surprised when they discover the costs paid by their plan that weren't openly disclosed to them. This in turn will lead to plan sponsors looking for less costly, more transparent alternatives to their existing platforms and providers.

That's where we come in. Any successful platform search starts with a sponsor that has a clear vision for their plan and the desired benefit for their employees. As a public service I am sharing with you several important questions IMCG asks any time we review current and alternative platforms for our clients. Think of them as tricks of the trade. If your current platform/provider answers "no" to any of the checked questions, you can improve your platform choice, because "yes" options do exist. To paraphrase the Rolling Stones song quoted above, "it never hurts to ask".

- ✓ ***ARE YOU USING THE LEAST EXPENSIVE FUND SHARE CLASS AVAILABLE?*** The landmark Tibble v. Cal. Edison case highlighted how important this topic is for plan sponsors to consider (as Cal Edison wound up making substantial restitution to their own plan). Always choose institutional share classes (no marketing/12b-1 "commission" fees, limited sub-TA "TPA payment" fees) whenever possible. Often you can save 25 basis points or more; those savings really add up for participant balances over time. Find out the best class of shares offered by the platform and if there are any stipulations attached to using them.

- ✓ ***DO YOU HAVE ENOUGH INVESTMENT DIVERSITY IN THE FUND LINEUP?*** Stocks vs. bonds, value style vs. growth style, small company vs. large company, international market vs. domestic market – it doesn't matter. Competing markets very rarely move up and down in unison. Your fund menu should have diverse options that allow participants to create their own ideal asset allocation that provides them with a risk-adjusted return goal that meets their individual needs.

- ✓ ***HAVE YOU ELIMINATED DUPLICATE FUND OPTIONS?*** Some plans offer over 50 funds, which often means they offer 10 large cap growth funds. How does a participant pick the right one? Hint: that's a rhetorical question. They usually don't pick the right one. Eliminate confusion by having an investment fiduciary select one fund per investment category.

- ✓ ***DO YOU USE A PROPER SCREENING PROCESS TO IMPROVE PERFORMANCE POTENTIAL AND RISK MANAGEMENT OF THE SELECTED FUNDS?*** You want to make sure you are selecting the best options possible for your plan. There are several factors to consider. If the platform claims to have a screening process, make certain they share the quantitative analysis it uses, and have an investment fiduciary like IMCG review it for you. Too many of the so-called fund screens used by platforms are cookie-cutter, formulaic and not forward-looking.

- ✓ ***ARE YOUR INVESTMENT POLICY AND RESULTING FUND MENU SET-UP TO TAKE ADVANTAGE OF FUTURE TRENDS AND AVOID VIOLENT BALANCE FLUCTUATIONS?*** Your plan should have the options in it to respond to market trends such as a rising interest rate environment, a recession, etc. A diverse menu, inflation-protected bond funds, foreign investment options for equities and fixed income, limitations on usage of sector-specific funds and other risk-distribution measures are important. Remember, this is a long-term savings plan, not a "get rich quick" scheme!

- ✓ ***WILL YOUR EXISTING PLATFORM NEGOTIATE THEIR CURRENT FEE STRUCTURE?*** In some instances, if you like your current platform, negotiating the fee down to acceptable levels for both parties is a reasonable solution. You can get antiquated charges like surrender fees eliminated, asset-based costs reduced, and TPA costs absorbed. Of course, this may be the same broker/platform combination that set you up with a sub-standard solution in the first place, so be careful. Just don't try to do this without having a backup plan in place in case they say no.

- ✓ ***DO YOU HAVE COMPREHENSIVE PARTICIPANT EDUCATION STRATEGIES?*** We can generally tell if a plan has strong education just by reviewing participant deferral rates. There is a very high correlation between well-run participant education programs and employee participation. Maybe your current provider is not onsite as much as originally promised. Maybe there are limited online resources. Use this part of the discussion to compare your current platform's participant education capabilities with alternate platforms. There are many aspects of participant education: resource materials for participants (hard copy and web-based), meeting structure (enrollment and ongoing education), advice (comprehensive wealth management vs. broker-based "plan only") to name a few. Try to excel at all of them.

- ✓ ***CAN YOUR PLATFORM HANDLE THE PLAN'S SPECIAL CIRCUMSTANCES?*** Do you work with self-directed accounts? Do you travel to multiple locations for education purposes? Is your payroll submission process compatible with our payroll? How do you handle participant loans? What is the process for an investment fiduciary to make changes to the fund offerings? How much work can you take off of my staff's desk? Can we put our logo on the statements and website? Always make sure that any new platform considered is able to handle everything you currently offer as well as everything you wish to offer.

- ✓ ***Do you act as an ERISA Section 3(38) investment fiduciary?*** An ERISA Section 3(38) Investment Fiduciary, hired by the Plan Trustee to be responsible for (and liable for) all investment recommendations regarding the plan. Not a Section 3(21) fiduciary (the plan fiduciary – they just outsource the true investment analysis). Not a "co-fiduciary" (a marketing term that holds no legal meaning and doesn't provide any protection to the plan sponsor). Not a directed bank trustee (you still have investment fiduciary responsibility – the bank is trustee of the assets, read: custodian). Not an Accredited Investment Fiduciary (AIF or AIFA - usually a broker who paid for the designation, who after a lifetime of making non-fiduciary-based decisions, is suddenly able to do everything in the client's best interest. AKA, a wolf in sheep's clothing.) Make sure that if someone claims to be a fiduciary for your plan, they sign a contract stating that they are a 3(38) Investment Manager and they list what their accountabilities are to you and your plan.

IMCG is proud to be one of Maine's only, if not the only, ERISA Section 3(38) Investment Manager. Hope that helps – that's all for now. In next quarter's newsletter, I will review the structural components of a good investment policy.

WEALTH MANAGEMENT UPDATE — *Tracy W. Rogers*

Developing a "Tax-Smart" Retirement Investing Strategy…

Diversification

One of the most important tenets of investing is diversification. While most people understand the importance of diversifying their investments, they often overlook the importance of diversifying the way their investments are taxed. This strategy not only entails managing the investments with an eye to tax efficiency during the accumulation period but also managing them for tax efficient income in retirement. Depending on what structure your investments are held in (qualified, non qualified, trust, life insurance, annuities, etc.) they can all be taxed differently. Most investors use their workplace retirement plan (401k, 403b, 457, etc) or an Individual Retirement Account (IRA) for the bulk of their assets. While this strategy may seem to be the best, it is usually focusing on the certainty of the current tax structure and not the uncertainty that may exist in the future.

Uncertainty

One of the reasons to diversify your investments from a tax standpoint is the inability to know where taxes will be down the road. For every change in the current tax code, there are many "proposed" changes as well. Most investors embrace diversification to mitigate risk in a volatile market but do not pay the same attention to mitigating the risks of a potentially volatile tax code. This uncertainty and the ever changing political landscape is just another reason to diversify and manage investments tax efficiently.

A recent study showed that during the past 80+ years, tax rates have been at current levels or lower only 14% of the time, leading many people to believe taxes have nowhere to go but up.

If it was that simple it could be planned for accordingly, but unfortunately there are always many other tax-related items that are on the political agenda and they affect everyone differently. Some of the many examples:

- Payroll tax relief: Will it be continued?
- Alternative Minimum Tax: Will the patch be extended?
- Capital gains and dividend income: Will that revert to ordinary income rates?
- Mortgage interest and real estate tax deduction: Will they be capped or changed?

In other words, how you are taxed, what you can deduct or get credit for to pass on to heirs is always changing. Thus, if you don't diversify your investments from a tax standpoint, you are at the mercy of what is going on in the political arena. One expert noted that the tax code "is always changing and if it isn't, someone is probably lobbying to change it" during the next election or on the next ballot.

Retirement income tax strategies

A recent study by the Investment Company Institute showed that among families with assets in defined contribution plans (401k, 403b, etc.) or IRAs, these resources accounted for a median 62.5% of their total financial assets. At the same time, Roth IRA accounts which are funded with after-tax dollars and are not taxable when money is withdrawn, comprised just 5% of all IRA assets. With tax rates being at historically low levels, many retirees pretax savings during their working years may be offset by higher taxes in retirement.

Investors should look to maximize their future retirement income streams through diversified and tax efficient strategies. Imagine that retirement income sources can come from three different ***buckets***:

1. Income that is fully taxable - 401k, IRA, Pension, CDs, Savings, etc.
2. Income that is partially taxable – Social Security, qualified dividends and long term capital gains from equities, etc.
3. Income that is tax free - Roth IRAs and Roth 401ks, primary residence sale, municipal bond interest, etc.

If an investor has money in all three buckets in retirement, it will allow them to maximize their retirement income based on their evolving personal situation. With these buckets filled, individualized strategies are then put in place. For example, someone may want to pass on highly appreciated stock and utilize the step up in basis for the heirs, so they draw down tax-deferred or tax-free accounts first. Others may plan on their spending years to be early in retirement so they will need to draw down all buckets to maximize the use of the marginalized tax brackets.

Planning is key

The goal of achieving a lasting retirement is more challenging now than in the past. Today's retirees can anticipate living longer than past generations. With the shift away from pensions the responsibility relies on individuals more than ever. It is important to build tax diversification into your overall portfolio and maximize efficiency by taking "tax-smart" withdrawals in retirement. If you would like to go over any of these concepts and how they might fit your situation, please don't hesitate to call us.

PLANNING CONCEPTS

PIIGS Weighing Down the Eurozone **_John Warme_**

With the advent of a truly globalized financial system, systemic vulnerability has become a significant factor in global markets today. Arguably catalyzed by the U.S.-born financial crisis that we have been dealing with for the past four years, the European Debt Crisis has been a major mover of the market over this last year. Many times this last quarter, the US equities markets would rally after the Euro markets closed, only for the rally to be quelled by some negative, early afternoon news from the Financial Times newswire. This dynamic, being such a major contributing factor to the volatility in the market this year, has left many investors wondering what exactly is going on "over there" and why is it affecting our markets so directly.

First, let's take a look at the Economic & Monetary Union of the European Union and the disparities among its member which have led to this crisis. Portugal, Italy, Ireland, Greece and Spain (or "the PIIGS" as they are often collectively named) have been a "poison pill" which has infected other, more austere, core Eurozone countries (think Germany, Austria, The Netherlands). The PIIGS ballooning financial mismanagement problems forces their better-managed counterparts to ponder questions like "should we try to bail them out?" or "should we let them default, and how would that hurt us?" It is these types of questions that, when publicly debated, contribute to market volatility and highlights the underlying problem with the Eurozone: though they share a common monetary policy through the European Central Bank, the fiscal policy differences throughout the region are stark.

For example, let's use Greece as a proxy for this "poison pill". After enjoying GDP growth significantly higher than the Eurozone average for consecutive years early in the decade, the spread between Greece's sovereign debt and the Eurozone average began to steadily increase. With the service sector comprising roughly 76% of its GDP (IMF), the Greek economy is especially vulnerable to global downturns. As the global financial crisis developed through 2007 and into 2008, Greece's debt as percentage of GDP began to grow from an already outrageous 97.4% in 2003 to 126.8% with a budget deficit of 13.6% of GDP in 2009 (IMF) . . . *all this while the maximum sovereign debt to GDP percentage allowed for inclusion in the EMU is 60%, and the maximum budget deficit as a percent of GDP allowed is 3% of GDP!*

In short, Greece was spending and making entitlement promises way beyond its means in an effort to tighten wealth disparities in the country. Their financial mismanagement feeds a vicious cycle. A borrower with a higher likelihood of default (Greece) will be burdened with higher borrowing costs. As a result, interest rates on Greek debt skyrocketed. As of December 31, Greece ten year bonds are currently trading in the secondary market at an absurdly high yield of 35.06%. Unlike the United States, Eurozone sovereignties cannot "print" their own money to ensure solvency or to debase the currency in order to make their debt more affordable. This leads us to where Greece is currently: insolvent, propped up by its neighbors and flirting with a flat-out default.

The debt crisis has had a terrible effect on the financial institutions of Europe, where most of the PIIGS sovereign debt is held and has created a liquidity crisis within these institutions. The European Central Bank (ECB) is charged with monetary policy for Europe, but functions differently than The Federal Reserve does in the U.S. Instead of increasing liquidity through the purchase of treasuries, the ECB injects liquidity into the Eurozone by short-term repo contracts with financial institutions which are collateralized by bank assets. In a catch-22, as the balance sheets of these institutions have been diminished by PIIGS sovereign debt, so has their borrowing power at the ECB. To add insult to injury, Greek creditors were forced to take a 50% write-down ("haircut") on the debt they hold.

A new era of austerity is being forced upon much of Europe. The PIIGS nations can no longer leverage their balance sheets beyond sustainable levels. Greece has already passed difficult austerity measures which unfortunately sparked the violent riots of the latter half of 2011. It turns out people do not like to be forced to accept diminished entitlements regardless of its effect on the "greater good".

We at IMCG will continue to closely monitor the situation in Europe and factor it accordingly into our economic outlook to best serve our client portfolios.

Happy New Year… From Congress? ***Ben W. Daigle***

Everybody remembers the old saying, "Nothing in life is certain but death and taxes."

Even though the expression still applies today, Congress has agreed to give the American worker a break on the tax portion by passing a two-month extension of the payroll tax cut, along with a Medicare reimbursement "doc fix" and extension of unemployment insurance benefits. This two-month extension is a patch that will be used to give Congress more time to negotiate and complete a larger 12-month extension of these benefits that the Republicans have been requesting from the beginning.

So, what does this bill actually mean?

For the 160 million people currently working and paying Social Security payroll taxes, for two months until February 29th, we will continue to pay the current 4.2 percent rate and delay reverting back to the old 6.2 percent rate (which would have occurred on January 1, 2012). The payroll tax extension will save about $40 for every bi-weekly pay period or around $1,000 in yearly savings for the average American worker.
Also, included in the bill is a two-month extension of unemployment benefits for those currently out of work and actively looking for a job. This renews federal benefits averaging $300 per week for the long-term unemployed. Additionally, the bill also delays a scheduled 27 percent cut in payments to Medicare physicians. Lastly, the bill requires House and Senate leaders in both parties to name negotiators to work on a bill extending the payroll cuts

for a year, extend federal jobless benefits for the long-term unemployed and keep Medicare payments to doctors at their current levels.

On a side note: curiously, the bill also requires President Obama to approve TransCanada's application for the construction of the Keystone XL oil pipeline from Canada to Texas within 60 days unless he declares the project would not serve the nation's best interest. Who says lobbyists have lost their touch?

By now, you might be asking yourself how we will pay for these extensions. Congress has decided to cover the estimated $33 billion cost of the extension by increasing home loan guarantee fees charged to mortgage lenders by FannieMae, FreddieMac and the Federal Housing Administration. The fees will go up by one-tenth of 1 percent (10 basis points). This fee will be passed on to homebuyers and will apply to any new purchases or refinances starting January 1, 2012. For example, on a $200,000 mortgage the fee will increase a borrower's cost by $17 per month. This increase in loan guarantee fees is expected to raise about $35.7 billion in revenue over 10 years.

In the end, the payroll tax cut doesn't feel like much of a savings for each individual worker, but if used wisely, $1,000 a year could end up helping fund longer-term financial goals. It's something to think about as part of your ongoing financial plan.

Population Growth and Investing ***Chris Walker***

The Census Bureau recently reported that the population of the United States grew this year at its slowest rate since the 1940's. The population grew approximately 2.8 million people from April 2010 to July 2011 for an annual increase of approximately 0.70 percent. This marked the lowest annual growth rate since 1945, when the population fell by 0.30 percent.

There are many reasons why this is occurring. The immigration level hit its lowest point since 1991, as a weak labor market appears to be contributing to this slowdown. Immigration net increase levels were above 1 million people per year up until 2006, which also marked the beginning of the housing meltdown. The net annual increase ending in July of 2011 was estimated to be 703,000. Net immigration from Mexico is close to zero and this level has not been seen in some 40 years.

The birth rate is down 7.3 percent from 2007 to 2010. In the year ending in July 2011, there were four million births in the United States. This is the lowest level since 1999. During the Great Depression, the birth rate in the United States fell by almost one third. The aging of the Baby Boom generation is also contributing to a long-run trend of declining natural population increase.

The slowdown in immigration, combined with the decreasing birth rate and the natural aging of the United States is worrisome for a few reasons. The ability of the United States to maintain and increase standards of living will depend on keeping a large share of our population in the workforce. Growth is needed to replenish our younger working-age ranks. This is critical in order to support the growing older population. Also, population growth itself is a reflection of society's optimism about our current state and future opportunities.

William Frey, a demographer with the Brookings Institute states, “We don’t have that vibrancy that fuels the economy and people’s sense of mobility. People are a bit aimless right now.”

The BRIC nations, (Brazil, Russia, India and China) which contributed almost half of global growth in the past decade, are also facing the aging population challenge. Together the BRIC nations account for about 25 percent of world gross domestic product.

Why is this important?

New growth economies such as Indonesia, Turkey, Egypt and Mexico may be countries that start to receive investment inflows. All four have large young populations that could help promote growing economies.

Whether it be the United States, the BRIC nations, developed nations or future growth economies, one thing will remain true at IMCG. We will continue to invest in outperforming companies that provide solid dividends within a globally oriented and value-based investment philosophy.

INSIDE THE MARKETS — FRANCIS J. DAVIES, III

Further Complications in the Divorce Process

As a member of the Institute for Divorce Financial Analysts (known as a CDFA), the only one within 50 miles currently, I help on some difficult divorce settlement issues. The role of the CDFA includes acting as an advisor to one party's divorce lawyer or as a mediator for both parties when complex financial assets are involved. One such complicated asset that is becoming much more common in divorce negotiations is the employee stock option plan.

These plans were traditionally reserved only for key executives, but not any longer. Corporations have found that this type of deferred compensation creates an interest in the enduring health of the firm within its employees. It is a more fitting incentive when trying to foster long-term thinking and strategizing than rewarding short-term results with an annual bonus (a form of compensation blamed for much of the reckless activity in the financial sector).

These plans and all their complexities are not well understood by most family lawyers or judges. The valuation process alone is a significant undertaking, usually relying on the Black-Scholes model. This is a responsibility that a CDFA might be able to both accomplish and be able to explain to the interested parties. It is important to note that a CDFA is neither a lawyer nor a tax specialist. We work with our clients and their professional advisers to try and ask the right questions; the answers are vetted by the lawyers and accountants.

Most state courts consider options granted and vested during the marriage to be marital property. Beyond that, it gets murky. For instance, since an option is a reward for previous work, what of options granted after separation to reward work done during the marriage? Or options granted during marriage to reward work done before the wedding date? The coverture fraction can change greatly depending on the choice of factors.

The case most often cited when discussing stock options as marital property is Wendt v. Wendt, a 1998 decision in the Connecticut divorce of Gary Wendt, who was then the Chairman of the GE Capital. It is often said that this divorce changed the way courts view the financial arrangements in marriage, particularly the contribution a stay-at-home mother, like Lorna Wendt, makes in the career of her executive husband.

If one of the spouses in a divorce proceeding is fortunate enough to work for a company that grants equity participation to its employees, the value of that asset can be as significant as the marital home. Deciding on a method for valuing and dividing it can be confusing. Some of the variables to consider:

- Stock options can be either qualified (received through an incentive stock option plan or employee stock purchase plan) or nonqualified (the method more in use these days, usually in the form of restricted stock units).
- Qualified stock options have a special tax status that nonqualified options do not. There are several qualifications for the preferred tax status. The restriction most troublesome in divorce is that these options can only be granted to employees and cannot be transferred except upon the death of the employee.
- The options can be vested or unvested. The company places restrictions on the employee's ability to exercise the option, normally allowing a percentage per year over the vesting period.
- The option is issued at the grant price (the stock's value on the grant date). If the stock price has declined since grant date, the options may be worthless.
- As noted above, many companies have moved to issuing restricted stock units (RSU) rather than options. This was partly done to address the problem of worthless options. An RSU grants the actual equity to the employee - not an option to purchase the equity. This way, as long as the stock is worth something, so is the RSU.
- RSU valuation is slightly less complicated because of the certainty of ownership - but still must discount future value and consider the variability (or volatility) of the underlying stock.
- There are two distribution methods: deferred distribution and present valuation both of which have their benefits and drawbacks.

Much of the decision process depends on what the employer allows. Some will allow nontaxable transfers between spouses (although I have never come across a company that did) which greatly simplifies the process. A CDFA can use their knowledge of tax law, asset distribution and short- and long-term financial planning to assess whether a settlement is equitable not just in the present, but down the road.

UPDATE

The IMCG-web site (www.imcgrp.com) will be wrapping up its extensive restructuring and renovations during the 1st quarter of 2012. Thanks to the expertise of Huard Marketing (www.huardmarketing.com) and Gnosis Studios (www.gnosisstudios.com) we're looking forward to the enhancements and upgrades of our internet presence. Anticipate an electronic announcement as we close in on spring 2012.

SAVE THE DATE

The Center for Grieving Children is in its 25th year and will be holding their "Celebrating Hope" gala dinner and auction Friday February 3rd at the Holiday Inn By The Bay in Portland. Additional information and tickets can be found at www.cgcmaine.org.

The Community Schools at Opportunity Farm and Camden has a number of events scheduled for the first part of 2012. The Farm Campus will hold and Open Mic/Coffee House the evening of February 9th as well as a Community Dinner April 12th – both events are free but RSVPs are appreciated. In addition, the Camden Campus will be holding its latest reprise of Dancing With The Local Stars on April 27th at The Camden Opera House – additional information can be found at www.thecommunityschool.org

The Dream Factory of Maine is also celebrating their 25th anniversary this year and will be holding its *19th Annual Child's Play Golf Benefit* to raise funds for its mission of granting dreams to the critically and chronically ill children of Maine. Scheduled for Friday June 1st 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.