INVESTMENT MANAGEMENT & CONSULTING GROUP

VIEWPOINTS

2ND QUARTER 2012 ADVISORY NEWSLETTER

MARKET COMMENTARY

FREDRIC W. WILLIAMS

Uh oh – Rut Ro (Ro)…

With all due deference to Scooby-Doo's mystery solving communication skills, the "Rut Ro" we are referring to is the traders' current risk-on risk-off (RoRo) acronym describing the globe's capital markets' manic approach to greed and fear within the context of a constantly evolving macro-economic environment. Just as in last year's roller coaster ride that was instigated by forces other than an analysis of current financial fundamentals, the 2nd quarter of 2012 was the (bi-) polar opposite of the risk-on investment focus that we had to start the year. Fear crept back into the markets in the form of Euro- and Sino-centric trepidation surrounding the solvency of the former and the economic landing path of the latter. This moved the trading "crowd" out of anything with a modicum of uncertainty (risk-off) and into the likes of U.S. Treasuries and German Bunds – neither of which provide much in the way of a return *on* one's investment, but instead provided comfort with the assumed return *of* ones investment that skittish investors require during periods of market stress.

This "everyone in the pool-everyone out of the pool" dynamic has been mentioned in this space in the past and has become increasingly the norm over the last decade – often times at the detriment to the investing public. This myopic view of the investing discipline has distorted reasonable expectations for time horizons and put investors in a position where they're unable to see the forest for the trees, thereby reducing the likelihood of successfully achieving their articulated goals and objectives.

> *"Most investors today…are in the here and now and are not paying attention to the bigger picture. It is estimated that almost 80% of all stocks are traded electronically based on computer models and algorithms whereby traders are in and out of markets within milliseconds. Hundreds of orders are capable of being entered within a second, creating abnormal market volatility and wild swings in the stock prices that have little to do with a company's long-term ability to generate excess cash flow (which eventually determines intrinsic value).*
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> *"Volatility and lack of confidence in markets, in turn, has reduced time horizons over which investors and analysts are willing to put their neck on the line. Rather than relying on and discussing a company's ability to produce free cash flow over two or three years, analysts focus on quarterly "misses" or "beats" – buying or selling before and after quarterly earnings releases with three-day to three-month prices targets.*

"But the shorter the time horizon, the lower the probability of being right. Waiting can be frustrating at times, as most investors tend to obsess over whatever happened in the markets most recently, assuming things will be that way "forever". Most market fads and/or trends last longer than anticipated, but "forever" usually ends unannounced."

R. Olstein, MarketWatch 4/20/2012

From a macro asset allocation perspective this has expressed itself as a continuation in the movement away from equities and into bonds – stocks are just plain out of fashion to Jane and Joe Mainstreet. During the 2nd quarter nearly $45 billion was pulled from stock mutual funds, with more than $70 billion flowing into bond funds as retail investors migrated to the perceived safety of the fixed income market. Going back to 2007 a cumulative $350 billion has flowed out of equity funds while more than $1 trillion has poured into fixed income funds – changing the overall mix that consumers held from 55% stocks and 15% bonds in 2005 to 45% and 25%, respectively, in 2011. Unfortunately, retail investors have tended to be contrarian indicators as highlighted by the old saw that says the stock market is the only market where customers buy when prices are rising and flee during a sale.

Stepping back and putting the last twelve months in perspective provides both a relative and absolute backdrop with which to see where we might be in the risk/reward spectrum. The 10 year Treasury at 1.66% is half what it was a year ago (the beneficiary of the above mentioned rush out of equities and into bonds) and emerging market equities are off 18%, something that is indicative of a risk-off fear flight.

"Interestingly, while the S&P 500 is about where it was 12 months ago, Brent crude oil is down 12.5%, industrial commodities have been crushed and the euro is 12% weaker against the dollar over the same span. This challenges the common view that stocks would merely move in lockstep with those other easy-money beneficiaries, and like them would suffer without more of the Federal Reserve's quantitative-easing generosity. Finally and not trivially, U.S. stocks are a bit less expensive today based on past and forecast corporate profits than they were last Independence Day." *M. Santoli, Barron's 7/2/2012*

Additionally, the financial media's tendency to over-analyze economic minutia on a minute by minute basis has obsured some general trends that are supportive of a bottoming process that would be constructive for equity prices.

"Progress in Europe is coming amid mixed economic indicators in the U.S., the latest of which have been relatively positive. Durable goods orders were surprisingly good in May, and are now running 8.1% above last years pace. More importantly the devastated housing market is showing signs of new life. New home sales jumped 7.6% in May, far more that economists expected, and now are almost 20% above the pace seen 12 months ago while existing homes are moving at about a 10% stronger pace than May 2011."

V. Scully, S&P 7/4/2012

Combine these macro observations, the ongoing level of pessimism cycling through the markets, along with the overly crowded trade into the bond (specifically Treasuries) market and the cauldron suggests that there may be limited downside from these levels in the equity markets – particularly if one has a reasonable time line of 3 to 5 years. It's also possible that much of the fright flight assets have been rung out of the equity markets, are sitting contentedly (so they think) in the bond market, and may be caught by surprise when a movement up in interest rates adversely impacts their bond mutual fund market values. This might represent a latent demand that could, in returning to more normal equity allocations, provide a significant and ongoing bid to equity prices as the globe's economy slowly heals and recovers.

As the epitome of a patient long term investor, the Sage of Omaha has always been helpful putting things in perspective so we can view our current circumstances within broader lens:

> *"In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497."* *Warren Buffett*

Nervous investors expecting bell ringing, or flag waving, to indicate some sort of all clear will likely always be kept waiting since no such signal exists in either the markets or the economy. Instead we are forced to rely on an assessment of conditions and trends within the context of historical precedent to determine direction – something that will always be the result of experiential analysis and not a defined sign post in the midst of an economic intersection. To once again quote the mid-west's pre-eminent investment mind:

> *"In the business world, the rearview mirror is always clearer than the windshield."*

We accept the world's uncertainty and rely on tested disciplines, like focusing on cash flow from your investments and favoring low price-earnings and high-dividend companies, as amongst the best strategies for successfully navigating turbulent times.

EQUITY MARKET OVERVIEW — INVESTMENT POLICY COMMITTEE

Second Quarter Rewind…

After the opening quarter's equity market exuberance, Q2 2012 brought renewed volatility and reigned in the animal spirits a bit as the aforementioned "risk-off" trade moved to the forefront amidst resurgent concerns surrounding the Euro zone.

> *"Volatility also returned after a calm start to the year. The Dow posted 22 days of triple-digit moves during the second quarter, compared with six in the first quarter."*
> *WSJ 7/2/2012*

The domestic stock markets moved lower starting in April – not bottoming until early June – as investors digested daily headlines from signs that China was slowing, to the sovereign debt challenges of Italy and Spain. Added to that was the policy-maker dithering on both sides of the Atlantic, with Washington ramping up election season rhetoric in the face of our looming "fiscal cliff" and Brussels seemingly replete with diametrically opposed ideologues with regard to solving the continent's fiscal and financial woes.

As the quarter drew to a close, expectations were so low for the Euro-zone leaders' most recent installment of their "summit" gathering (likely due to the fact that they'd gone 0-for-

18 in their previous trips to the plate) that there was genuine surprise when, working into the early morning hours, they actually came up with a new set of agreements to recapitalize struggling banks and promote growth. They announced the creation of a €120 billion stimulus package, that bailout funds would flow directly to banks rather than pass through government hands, and allowed the €500 billion European Stabilization Mechanism to buy sovereign debt in the open market once the bank supervisor for the European Union has been set up. Needless to say, putting this much meat back on the bone rekindled some of the animal spirits, albeit perhaps temporarily:

> *"Came Friday, the final trading session of the second quarter, and suddenly all was right with the world. Markets around the globe soared, very much including our own suddenly buoyant bourse. What lit the fire was another surprise—this one sprouted from Brussels. Working (or at least staying awake) until the wee hours of the morning, the European Union parleyers—yes, the same crew that cast a pall over markets virtually everywhere on Thursday—came up with a brand-new grand plan to bail out the growing number of financial invalids in their ranks, Spain and Italy heading the list. Voila! Just like that—Happy Days were everywhere again."* *A. Abelson, Barron's 7/2/2012*

Much like last year, jittery investors chose to shoot first and ask questions later, continuing the aforementioned aversion to equities in lieu of the perceived safe havens of the fixed income markets. The domestic equity markets gave back a chunk of their first quarter run-up with the Dow Jones Industrial Average down 2.5% in the 2nd quarter, although still ahead 5.4% for the year, the broader S&P 500 dropped 3.3%, leaving it up 8.3% YTD, while the NASDAQ gave back 5.1% in the quarter, but still advanced 13% through the first half of 2012.

The other developed world bourses suffered similar fates, with London's FTSE 100 down 3.5% in the quarter, leaving it flat for the year, Frankfurt's DAX declined 9.9%, but was still up 8.8% YTD, while the Paris CAC 40 was off 6.7%, sneaking ahead 1.2% for the year's first 6 months. Japan felt the effects of the concerns for China's growth rate, given the significant level of trade that exists between the two countries, with Tokyo's Nikkei dropping 9.8%, although still ahead 6.5% for the year.

The 2nd quarter's "risk-off" theme also hit the developing markets as well, although the impact varied from country to country. Again using the BRIC complex as a proxy for the emerging markets, Brazil saw the Bovespa slump 17.9% for the quarter, leaving it down 4.2% for the year. Although China dropped only 1.7%, still up 1.2% YTD, Russia lost 17.8%, off 5.8% through 6 months, and India inched ahead 0.2%, finishing the first half of 2012 ahead by a robust 12.8%.

And in this ever-changing "Ro-Ro" world, we continue to stand by our close from last quarter:

> *"We continue to believe that the marginally improving macro-economic picture, coupled with attractive equity valuations are providing selective 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."* *IMCG VIEWPOINTS, Q2 2012*

How Low Can They Go?…

After a less than stellar start to the year, the aforementioned "risk-off" fear flight temporarily restored the bond market's luster as assets poured into Treasuries, driving yields to historic lows during early June. The first quarter's dalliance with allocating assets to riskier holdings was effectively squelched as external concerns forced investors back into domestic sovereign debt:

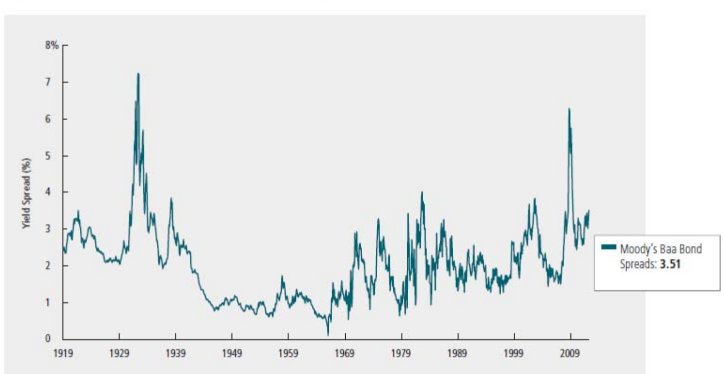
> *"More than any other factor, the path of U.S. bond yields so far in 2012 has been determined by forces beyond America's shores, primarily the continuing European debt crisis. And largely for that reason, most interest-rate forecasters were wrong-footed by events that sent the yield on the benchmark Treasury 10-year note to record lows, along with other government securities that also provided safe harbors for investors, notably those of Germany and the U.K."* *R. Forsyth, Barron's 7/2/2012*

While the first three months of the year were characterized by steady global growth and elevated investor optimism, the second quarter brought a steady stream of negative news. Most important, the European debt crisis moved back into the forefront with headlines suggesting that Spain's banking system was experiencing severe stress. As was the case in each of the past two summers, investors again grew nervous because of the seemingly unlimited risk posed by Europe's ongoing fiscal problems.

Treasuries strengthened to hit the record lows on June 1st as investors fled to "safe haven" government debt in the wake of continued turmoil from the European sovereign debt crisis. The Federal Reserve has made clear that it intends to keep interest rates low for an extended period, thereby anchoring the short end of the yield curve at close to zero. This renewed aversion to risk has pushed the "crowded" trade in domestic sovereign debt to the level of negative real yields, while opening up opportunities for potentially higher returns in other parts of the investment grade bond market.

Moody's Corporate Baa Bond Spreads *1/31/19 through 5/31/12*

Investment-grade corporate bond spreads have continued to normalize since the financial crisis, but they remain high by historical standards—despite most issuers' healthy credit profiles—offering investors potential income opportunities.



Source of chart data: Bloomberg, Moody's and the Federal Reserve, 5/31/12. Corporate bonds are represented by Moody's Baa Bond Yield. Baa is a medium-quality, investment-grade bond rating assigned to a corporation based on the issuer's ability to pay interest and repay principal upon maturity. Long-term treasuries are represented by the long-term U.S. Treasury yield. The "spread" indicates the difference in yield between corporate bonds and long-term treasuries. Performance is shown for illustrative purposes only

As can be seen in the chart above, yield spreads are down from their highs during the financial crisis, but still elevated from a historical perspective, due primarily to the ongoing political and economic concerns both domestically and overseas.

The news on the economic front was also unfavorable. Here stateside, economic data came in at disappointing levels after a solid first quarter. While this raised hopes that the Federal Reserve would step in with another round of quantitative easing, the Fed opted for the middle ground of extending its Operation Twist program (which seeks to keep longer-term rates down by selling short-term bonds and buying longer-term issues) through the end of the year. Growth was also disappointing overseas, as China continued to report weak numbers and Europe likely moved into a recession.

All this seemly dismal data was actually constructive across the broader bond market as macro concerns pushed assets into the fixed income sector, driving yields down and prices up. Treasuries rebounded and were up 3.4% in the quarter, leaving them ahead by 2.1% for the year, while the aggregate bond market (according to Barclays) only added 1.9%, but was still up 4.4% through the 2nd quarter.

Given the "Q2-fear-du-jour" trade, Treasuries were bid up as the 2-year note closed the quarter yielding 0.30%, down from 0.33% at the end of the first quarter, while the 10-year note touched 1.45% on June 1st before closing at 1.65%, down from 2.36%, while the "nostalgic" 30-year bond, which also hit a record low yield of 2.51% on the first of June, saw its yield drop from 3.34% to 2.75% as we exited the second quarter of 2012.

Although we see the late-Q2 break-through at the recent European Summit XIX (seriously – they've had 19 summits since the start of the financial crisis) to be a positive first step in resolving the continent's woes, we expect central banks to continue to maintain downward pressure on rates across the yield curve as they work to get our collective economies out of intensive care and back on their feet. Once un-tethered we would expect rates to be pulled upward as a result of money supply and inflationary dynamics. We continue to favor TIPS, floaters and select coupon credits in the intermediate maturity range, as we feel they offer reasonable opportunities in the fixed income arena.

FIDUCIARY CORNER — STEPHEN L. EDDY

The Other Shoe…

Odds are that you have not heard of Judge Nanette Laughrey. She presides in U.S. District Court, Western District of Missouri Central Division, and you would likely have never had a reason to benefit (or suffer) from any of her decisions. However, she has, almost overnight, become the best friend of every employee who participates in a retirement plan and the worst nightmare for corporate retirement plan committees everywhere.

You see, what Judge Laughrey did at the end of March of 2012, was issue an 81-page opinion in the landmark case *Tussey, et al. v. ABB, Inc.* – the actual hearing concluded in January 2010 after an unusually lengthy four-week bench trial with a participant suing his employer for breach of fiduciary duty in their 401(k) plan. The two year wait was worth it. Her findings: that there were several breaches of fiduciary duties under ERISA. The net result: the company (ABB), the head of the Employee Benefits Committee (named individually), both the Employee Benefits and Pension Review committees, and Fidelity (the mutual fund company that provided servicing) were ordered to pay a combined judgment of almost $37 million.

The Facts:

- ABB, Inc. is a global power and automation technology company that employs roughly 135,000 people, both union and non-union
- ABB selected Fidelity Trust to provide recordkeeping and other administrative services to its qualified 401(k) plans
- Fidelity also provided services for ABB's defined benefit pension plan, nonqualified deferred comp plan, health benefits and payroll services
- Fidelity Research (a Fidelity affiliate) provided investment management services
- The plaintiffs (Tussey, and other plan participants) alleged various breaches of fiduciary duties with regard to the relationship between Fidelity and ABB, among them how funds were selected and how "float" earnings were handled by Fidelity which held the plan assets

Four Critical Findings That Should Concern Every Plan Sponsor

The Plan and/or Plan Sponsor:

1) failed to monitor or renegotiate fees as the plan assets grew
2) failed to calculate (or more precisely be aware of) the amount that Fidelity was receiving from revenue sharing arrangements
3) did not follow the Investment Policy Statement (IPS), which contained provisions for investment choice and revenue sharing
4) did not listen to the advice of a third-party consultant who informed them that they were paying too much

The company violated the IPS referred to in item 3 by selecting more expensive share classes for their platform when less expensive ones were available AND by replacing a well-performing, low-cost option with more expensive options that were not performing as well. In essence, Fidelity was recommending changes to the funds that were not in the best interests of the plan participants, but rather to reduce ABB's out-of-pocket expenses and increase Fidelity's revenue. As industry expert Mark Griffith put it: "the moral of the story is that under ERISA you cannot use other people's money for personal gain". As the assets (and fee) continued to grow, Judge Laughrey saw no commensurate increase in services provided, hence the judgment.

Interestingly, we see the real (not potential) value of an independent investment fiduciary/consultant like IMCG. Our job is to keep our clients out of this type of trouble. We do it by:

- charging a flat fee (not asset-based), and capping it
- constantly reviewing ways to reduce fees to participants and improve performance by utilizing the least expensive share class available and encouraging vendors to use true open architecture
- measuring funds against internally developed indices, not just category averages, which show a more accurate representation of true comparative performance and expense differential
- drafting and tracking investment policy provisions
- and, most importantly, NEVER taking "finder's fee" or revenue sharing payments from a platform or vendor because we do not want the slightest appearance of any conflicts of interest influencing our recommendations for our clients

Ironically, ABB had a consultant, but didn't listen to the advice. As a plan sponsor, you have to ask yourself if a judgment against you at 2.4% of the value of your plan's assets is worth it.

PLANNING CONCEPTS

So, who's this Cliff guy everyone's talking about? ***John Warme***

By now it is likely that you have heard about one of the most nascent threats to the fragile US economic recovery: the so-called "Fiscal Cliff". That's right, in addition to the "headline contagion" coming across the Atlantic from the severe structural and economic deficiencies of (and until last week, un-pointed policy reaction to) the eurozone debt crisis, we have a homegrown crisis of our own. The question on this side of the pond is whether or not the polarized political environment in Washington will lead to policymakers driving the US economy straight off the avoidable "fiscal cliff." The commonsensical answer would be "of course not." Unfortunately, if anything, last year's debt-ceiling debacle adds a layer of doubt that much can be accomplished in Washington that requires any degree of compromise.

So, what is the "fiscal cliff" and what are the implications? The fiscal cliff refers to the December 31, 2012 expiration of tax-cuts coupled with the enforcement of certain spending cuts the following day. The combined hit to US economy is expected to be in $720 billion range . . . hardly a hit that it can sustain in such a vulnerable state.

The January 1st effective date spending cuts, referred to as the "budget sequester", would be an especially hard hit to employment, the Achilles heel of the current recovery. The sequester is set to slash $100 billion from the federal budget in 2013 but could come at the expense of up to 1 million jobs by 2014 according to the National Association of Manufacturers. Surprisingly, this would largely affect private sector jobs, many of which would be manufacturing jobs along the supply chain fed by defense spending. The budget sequester is a product of the aforementioned debt-ceiling standoff and a reaction to the ballooning deficit under the current administration, part of which was a response to the recent economic crisis.

Getting most of the attention in the debate however, are the expiring tax-cuts. They are largely Bush-era cuts enacted in 2001 & 2003 and extended in 2010 as well as the 2010 temporary payroll tax reduction. The tax debate is certainly beyond the scope of this article, but the essential fact is that this expiration will effectively remove liquidity from the economy by reducing the amount of money taxpayers net and thus reducing the amount that they pump back into the economy via consumer spending, the cornerstone of economic activity.

With the combined impact of raised revenues and reined-in spending, the main beneficiary would be the federal deficit. The Congressional Budget Office estimates that the 2011 deficit of 8.5% of GDP would be reduced to 1.2% of GDP by 2021, resulting in a total deficit reduction of $7.1 trillion over the period if no action is taken regarding the fiscal cliff. The numbers certainly look great; however it could be at a dire cost to an economic recovery struggling to get out of first gear. The short-term impact would be the aforementioned job losses as well as a retracting economy, likely to the tune of 1.3% of GDP spanning the first two quarters of 2013. This of course is the requisite span to consider it a recession. The current economy call ill afford a setback of this magnitude.

We would like to think that the gridlock in Washington is not so pervasive as to steer the US economy directly off this fiscal cliff. We undoubtedly have 6 months of political posturing and rhetoric ahead us until we find out our fiscal fate. Until then we can expect the uncertainty to have a dragging effect across the spectrum of economic indicators, most notably where it hurts the most . . . job creation.

IMCG NEWS

We are pleased to announce the following additions to the team of professionals at IMCG:

***JASON FOSTER* –** Has joined us as a Vice President and Portfolio Manager. Jason began his investment career at the regional firm of Legg Mason Wood Walker (now Morgan Stanley Smith Barney) as a financial advisor in 1998, works with both individuals and retirement plans and is a member of the firm's Investment Policy Committee. Jason has served on the University of Maine Farmington Advisory Board and is a past volunteer and educator with the Junior Achievement program. He is a Maine native, having grown up in the Lakes Region in the Bridgton/Naples area. He currently resides in Gorham with his wife Kristin and two young children Hadley and Braden.

***JAY FLOWER* –** Has also joined IMCG as a Vice President and Portfolio Manager. Starting his career in the investment management industry while living in Boston, Jay joined Legg Mason when he and his wife returned to Maine in 2005. Jay works with both individuals and retirement plans as well, and is a member of the firm's Investment Policy Committee. He currently serves on the Board of Trustees at North Yarmouth Academy and is also a native of Maine having grown up in Brunswick and Boothbay Harbor. He graduated from Hobart College in 1998 and now lives in South Freeport with his wife Julie and their two young daughters Liza and Kate.

We're excited that Jason and Jay have decided to advance their careers by leaving the brokerage business for our firm and the independent investment advisory business – we welcome them to our team!

WEB SITE UPDATE – We recently revamped our web site (www.imcgrp.com) so do drop by and pay us a "visit". We can also be followed on Linkedin (www.bitly.com/theimcgrp) and Facebook (www.facebook.com/imcgrp). Our heartfelt thanks go out to Huard Marketing (www.huardmarketing.com) and Gnosis Studios (www.gnosisstudios.com) for all their help with these projects over the last several months.

SAVE THE DATES:

Summers in Maine are the time of year when a variety of non-profit organizations continue 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:

> ***The Center for Grieving Children*** – Is holding its **"Fore" the Center** benefit tournament September 18th at The Purpoodock Club in Cape Elizabeth starting at noon. Additional information and registration can be found on their web site www.cgcmaine.org.
>
> ***The Little Dolphin School*** **-** Is having its **6th Annual Golf Tournament** on September 28th at Val Halla Golf Course in Cumberland. The Little Dolphin School Foundation has been a national leader in early childhood education since 1977, and the Foundation's scholarship and tuition assistance program is dedicated to solving a currently existing crisis of finding high-quality childcare services for low to moderate income families. A Maine-based non-profit organization, their learning centers in Scarborough and Westbrook, serve over 200 families per year in the Greater Portland Area. Additional information can be found at www.littledolphinschool.org.
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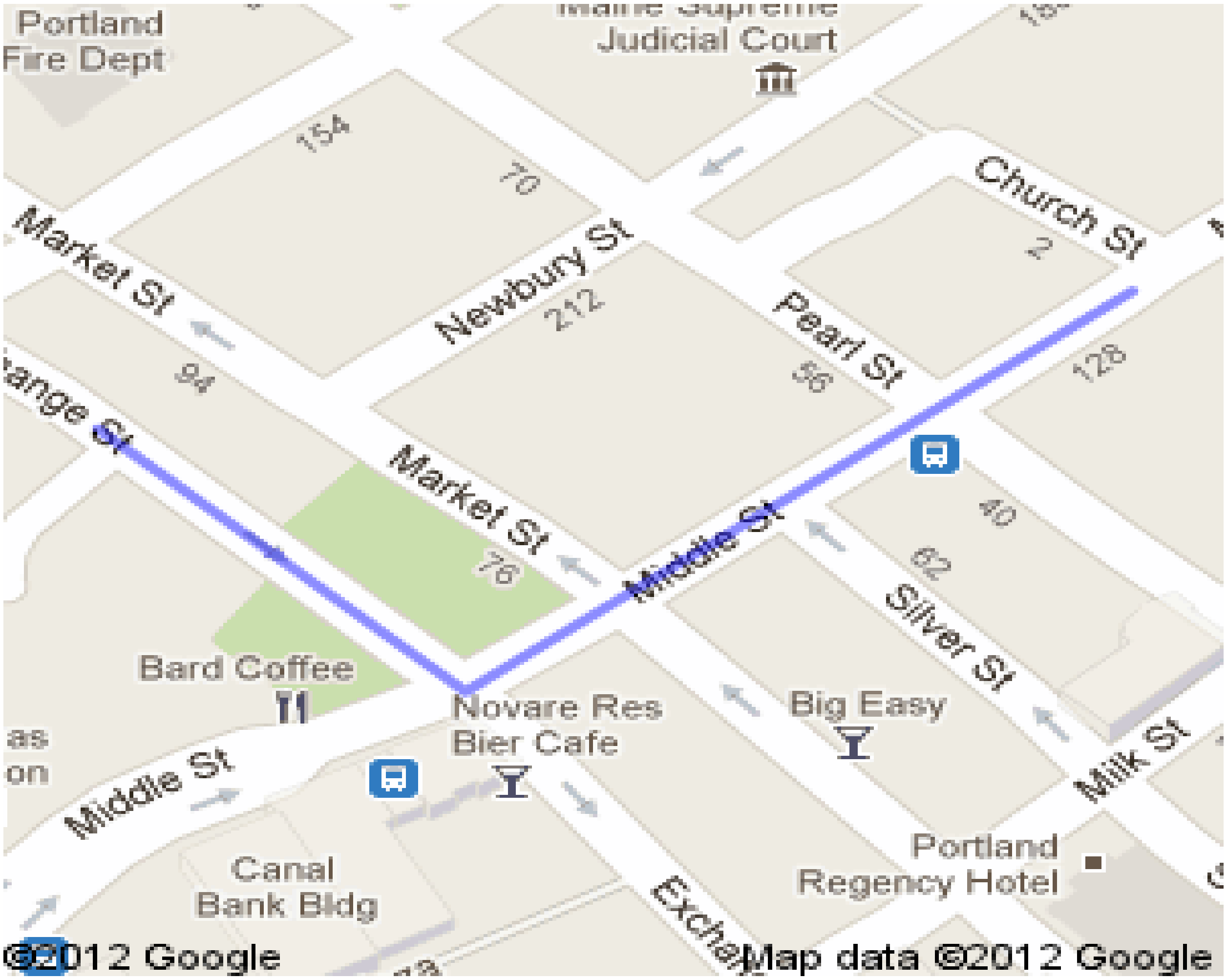
> ***The Community Schools at Opportunity Farm and Camden*** - Will host their annual "**Farm to Sea" Auction** on Friday, September 28th at The Masonic Temple in Portland from 6 p.m. to 9:30 p.m. All of the funds will support the mission of the newly merged school with campuses in Camden and New Gloucester. For more information, go to www.thecommunityschool.org where auction information will be posted and updated throughout the coming months.

NEW OFFICES – With our continuing expansion we have outgrown our current location and will be moving to new offices, taking the 2nd floor at 130 Middle Street in downtown Portland. As with our current location we will continue to provide access to a parking garage in the same block and directions to both the new offices and the adjacent parking can be found on our web page. Renovations are currently underway so we hope to be scheduling the move during August.

Our new offices are three blocks from our current location and we will provide parking next door in the Custom House Garage at 25 Pearl Street.



EDITOR'S NOTE: Since Jason and Jay's arrival has enhanced our writing depth off the bench, we have migrated to a rotating scribe format with our newsletter columns starting with this issue.