INVESTMENT MANAGEMENT & CONSULTING GROUP

VIEWPOINTS

2ND QUARTER 2013 | ADVISORY NEWSLETTER

MARKET COMMENTARY

FREDRIC W. WILLIAMS

Back Away From The Punch Bowl!…

"Alcohol may be man's worst enemy, but the bible says love your enemy."
- Frank Sinatra

Remaining true to the script outlined in 1955 by then Fed Chairman William McChesney Martin where he indicated that the duty of the Fed was to take away the punch bowl just as the party gets good, the mere hint that Chairman Bernanke was even considering reducing the level of "liquidity" at our current party caused a sharp pull back in the interest-rate-sensitive components of the globe's markets during the last half of the 2nd quarter. After years of unencumbered quaffing from the continuing iterations of the Central Bank's various "quantitative easing" (QE) campaigns, the prospect of a slight reduction in the rate of growth in our monetary supply caused the patient (our domestic capital markets) to tremble and shudder.

A great deal of teeth gnashing and hand wringing was brought on by the acknowledgment, albeit grudgingly, that QE4-ever can't in fact go on in perpetuity. At some point the Fed will need take the training wheels off of the economy and have it continue to improve absent government administered support. As Jay and Jason highlight in their stock and bond market commentaries below, the first quarter's unimpeded march upward hit a bit of a speed bump when the Fed Chairman had the audacity to suggest that the domestic economy was feeling better and might not need the punch bowl to continually be filled to the brim as a means of keeping it on the mend. Apparently there were those naysayers in the trenches of the capital markets who didn't share Mr. Bernanke's enthusiasm for the unsupported prospects of our nation's economic well-being.

The prospect of the Fed easing up on the monetary-stimulus accelerator was not a surprise, although the markets' reaction seemed a bit overdone. Both in 1994, and then again in 2004, when there were hints of possible interest rate rises coming from the Fed, the equity markets numerous short term corrections that were ultimately absorbed into the tide of rising stock prices. A less emotional view of the last six years of economic medicine would tend to support the rational conclusion that "tempered tapering" would soon be part of our interest rate lexicon. According to Barron's there have been 520 central bank rate cuts around the world, $33 trillion in fiscal and monetary stimulus, that half of the market cap for global government bonds are yielding less than 1%, and U.S government bonds are yielding the

Post Office Box 4802 ♦ 130 Middle Street ♦ Portland, Maine 04112
207.774.6552 ♦ 800.605.6552 ♦ FAX 207.775.2969
www.imcgrp.com ♦ info@imcgrp.com

lowest that they have in 220 years…all of which would suggest that lower rates over the next 3-5 years are likely not in the cards given the slowly improving, albeit glacial at times, global economy.

The mid-quarter market gyrations forced the Fed to deploy its Chairman in a PR-campaign offensive to clarify the concept of tapering as NOT being an increase in interest rates, but rather merely a lessening of the rate of increase in the accelerant being added to the punch bowl. After parsing this new narrative the markets responded and recovered most of May's losses, closing higher for both the quarter and the first half of 2013. Serial highs were hit absent the participation of retail investors though, who exited the bond bubble and sought the security of the miniscule yields in money market funds, despite the previous predictions of the media's talking heads who posited that these assets would immediately run to stock funds and propel the markets even higher. As we pointed out last quarter, with more than a trillion dollars having been dumped into bond funds over the last six years, this year's movement out is still in its infancy – fixed income investors will need to see declining bond values and rising stock prices, while experiencing the negative real returns of sitting in cash, to get comfortable with the transition to equities…something we think is ultimately inevitable.

From a macro asset allocation perspective we feel there are a number of themes continuing to develop that could provide longer term opportunities:

- **Bonds vs. Stocks:** We continue to favor dividend paying equities and are limiting our fixed income investments to those of short duration, as well as those opportunities in the inflation indexed and floating rate arenas. That being said, there are select opportunities in certain sectors, as Jason points out below.
- **Emerging Markets:** Although significant under-performers through the first half of this year, Jay suggests that this is an opportunity given their stronger sovereign finances, higher economic growth rates and favorable (younger) demographics. The UN Population Statistics for 2013 highlight that only three of the world's largest countries (U.S., Japan & Germany) are *not* in the developing world.
- **Latent Cap Ex Investment Demand:** From infrastructure to technology, cap ex has been on the back burner as the private sector's desire to invest in future growth and expansion has been hampered by political policy paralysis emanating from our nation's capital. We see opportunities in sectors like tech, energy, industrials and mining as being beneficiaries of diminishing Beltway gridlock, as well as the continuing improvement in the global economy.

And although constructive longer term on the domestic equity markets, we do feel that the market's run this year needs to be better supported by corporate profits and revenue growth, both of which are running at about 1/3 the rate of appreciation in the indices. Given the generally improving global economic backdrop, any market volatility could provide attractive opportunities and entry points for patient investors with reasonable time horizons.

Scribe's Note: It is with great sadness that this quarter we note the passing of Alan Abelson, a writer-extraordinaire with Barron's for 47 years. I began reading him weekly in the late

70's and frequently quoted him in this space since the mid-90's. His iconoclastic views and penetrating perspective provided clarity, and humor, in an industry devoid of both. Fred Hickey, editor of The High Tech Strategist and perennial Barron's Roundtable member (as well as a New Hampshire-ite) may have said it best: *"Possessing a sharp wit and even sharper pen, Alan Abelson was unsurpassed at carving up all the charlatans, con men, cheerleaders and frauds who populate Wall Street and beyond. Alan was a knight in shining armor to those who value truth above all."*

His brilliance will be missed.

EQUITY MARKET OVERVIEW — JAY FLOWER

When Bad News is Good News…

The second quarter for the equity markets was rather ho-hum right up until the point when Federal Reserve Chairman, Ben Bernanke, said he felt the economy was improving. He alluded to this terrifying concern during his testimony to Congress on May 22nd which caused interest rates to climb and reverse the upward trend of global equity markets. Further clarification of the Fed's plans came during a conference call after the FOMC's statement on June 19th when Bernanke detailed the reasons he feels the economic recovery is self-sustaining and, thus, it was time to begin to taper asset purchases (U.S. Treasuries and mortgage-backed securities at a current clip of $85 billion/month). This news acted as a catalyst for an overdue, in our opinion, correction. The equity markets needed to vent some steam after eight straight months of gains for the S&P 500. We saw indiscriminate selling across all asset classes and sectors. The S&P was down 3.9% in two days giving up almost all of the gains for the entire quarter as the chart below details.

Fortunately, as the chart also details, the markets recovered fairly dramatically during the last trading week of the quarter. Investors, we think, came to realize that an improving economy is a good thing. The subsequent economic data that was released seemed to support

Bernanke's position that the recovery may be picking up steam as consumer spending, personal income, new home sales and the Case-Shiller Home Price Index all came in ahead of expectations. While we need to continue to be prepared for more Fed-triggered volatile days we feel it is important to realize and take advantage of the fact that reducing stimulus is reflective of an improving economy and should act as a tailwind for equity markets over the long-term.

We thought it would be helpful to overlay the MSCI EAFE (green) and the MSCI Emerging Markets (red) over the S&P 500 (blue) to show that at times these markets have moved in lock-step while at others, such as the last week in June, the same cannot be said. On a year-to-date basis there is a large discrepancy of returns between the S&P 500 (+ 14%), the Developed International (flat) and Emerging Markets (-12%). While the Fed's actions focus on the U.S. economy it is clear that international and emerging markets stocks were hit even harder. Interest rates, for the most part, have moved in tandem in emerging markets with the U.S. rates which has had a negative impact on their currencies and thus to the equities in those countries. While expected growth rates in emerging markets, most notably China and Brazil, have recently been revised down our Investment Policy Committee feels the considerable underperformance of the broad asset class presents a number of select opportunities for future returns.

Since we resist the temptation to make bold market predictions we will borrow a recent one from the chief equity strategist at S&P Capital IQ, Sam Stovall. He recently provided an interesting factoid during a recent Yahoo Finance interview when he noted that every time since World War II the S&P 500 was up in January and February, the market has gone on to post a positive full-year return 26 of 26 times. "And the average total return (under those circumstance) was about 24-percent," Stovall says. "So with us up about 14-percent on a total return basis for the first half, if history repeats itself, we could be up another ten percent just to get to that average."

If he's right, that would land the S&P 500 at around 1,775 on New Year's Eve.

Table 1 - Index Returns				
Equities	*06/28/2013 Closing Level*	*Percentage Change Quarter-to-Date*	*Percentage Change Year-to-Date*	*Trailing 12 Months*
DJIA	14910	2.27%	15.18%	21.39%
S&P 500	1606	2.36%	13.82%	23.61%
NASDAQ	3403	4.13%	13.43%	21.15%
MSCI EAFE	1639	-2.09%	4.47%	23.46%
MSCI EM	940.33	-9.15%	-9.40%	6.73%
Fixed Income	*6/28/2013*	*3/29/2013*	*12/31/2012*	*6/28/2012*
2 Yr US Treasury Yield	0.36%	0.25%	0.25%	0.31%
10 Yr US Treasury Yield	2.52%	1.87%	1.78%	1.60%
30 Yr US Treasury Yield	3.52%	3.10%	2.95%	2.67%
	Levels			
Commodities	*6/28/2013*	*3/29/2013*	*12/31/2012*	*6/28/2012*
Oil (WTI)	96.56	97.23	91.82	77.69
Gold	1192	1598	1658	1559

Is It Really Over?...

Discussing the fixed income market for more than thirty seconds with anyone outside the financial industry profession runs the risk of putting the audience to sleep. The bond market simply does not have the glamor of the stock market. However, the second quarter proved to be the exception with fixed income stealing many of the headlines. What grabbed all the attention is the very real possibility that the secular 30-year bull market for bonds is over. The catalyst was the release of May's Federal Open Market Committee minutes revealing the debate within the Federal Reserve over the Fed's strategy on the continuation of quantitative easing (QE). If you are wondering what "QE" is, think of it as a series of cortisone shots to an injured athlete. It appears to improve his performance on the field, but too many injections over time may have serious consequences. Now the members of the Fed are chewing on whether to taper or even stop QE altogether should the economy continue to heal. The markets took special notice of Chairman Bernanke's comments on the subject:

> *"If we see continued improvement and we have confidence that it is going to sustained, then we could, in the next few meetings, take a step down in our pace of purchases."* *-Ben Bernanke, May 2013*

With the threat of stimulus being pulled, both bond and stock prices swiftly declined in price. A recent purchaser of a 10-year Treasury note saw their principal value drop 6% in a few short weeks while yields spiked upward. For example, the 10-year Treasury yielded 1.62% on May 2nd, by the end of June it was at 2.50%, a 54% increase. The average return on a high yield bond went from 5% to 6.75% and 10-year, triple-A municipal bond yields bounced from 1.65% to 2.6%, according to Barrons. All were staggering moves. IMCG has repeatedly cautioned about over-allocation to fixed income so the correction in bond values was not a complete shock, but the new opportunities created by the size and speed of the sell-off are a pleasant surprise.

The scope of the sell-off was evident by the magnitude of outflows from fixed income mutual funds and exchange traded funds. David Santchi, the CEO of TrimTabs Investment Research stated, "We estimate that bond mutual funds have lost $70.8 billion in June… while bond exchange traded funds have lost $9.0 billion." To put that into perspective: that nearly wipes out all of the dollars added to these fund categories for all of 2013 to date.

What opportunities do we see? Select issues and maturities have caught our attention. Municipal bonds are one example. For the first time in several years we are seeing investment grade municipal bonds paying over 4%. For an investor in the upper end of the tax bracket living in a state with an above average tax rate like Maine, that translates into a 6% tax-equivalent yield. This may not be an "all-in" moment, however with inflation over the last twelve months at 1.5% (we realize that is debatable), money markets near 0%, slow economic growth, and relatively low yields in sectors of similar quality, municipal bonds look attractive. At IMCG allocation of capital will be made with caution as investor emotions are still running high; should it continue after quarterly statements are digested further opportunities may arise.

The Other Other Shoe…

In the 2012 second quarter edition of our newsletter, I wrote an article for the Fiduciary Corner entitled "The Other Shoe". It reviewed the landmark Tussey v. ABB lawsuit which focused on missteps by ABB's Pension Review Committee related to excessive fees, improper use of fund share classes, self-dealing, revenue sharing and the investment policy statement. The judge ruled in favor of the Plaintiff and awarded a judgment of $37 million (this judgment, of course, has since been appealed).

Now another lawsuit with as much potential landmark impact on the industry as the ABB case has appeared on the horizon. Santomenno v. Transamerica Life Ins. Co. is a class-action lawsuit brought about by a participant regarding, guess what: excessive fees, improper use of fund share classes, self-dealing and revenue sharing. As Thomas E. Clark, Jr, JD & CCO of Fiduciary Risk Assessment, LLC wrote in an April 25, 2013 blog, this "little reported decision… has the opportunity to cause great heart burn (or worse) to insurance company platforms for retirement plans". This is potentially a landmark case because, unlike the typical "excessive fee" case (i.e. the Tussey v ABB case), the Plaintiffs are suing the bundled service provider and not the plan sponsor.

Transamerica immediately filed for injunctions and dismissal. The judge saw it differently and has allowed the case to move to the discovery phase (essentially meaning it wasn't thrown out of court as requested because the Plaintiffs made plausible allegations regarding potential fiduciary violations).

Two interesting components to the case: 1) the court criticized the fiduciary warranty included in the plan's contracts. This warranty is a representation of "fiduciary coverage" through an insurance policy sold by Transamerica in lieu of Transamerica being an actual fiduciary. The problem is that the policy is being paid for by revenue sharing from employee accounts, and not paid by the employer, which is a red flag for ERISA under the prohibited transaction rules; and 2) the facts of the complaint have led the judge to consider whether Transamerica is a fiduciary with respect to monitoring its own compensation. We'll update you on this case as it develops.

The Lessons Learned

- These lawsuits are becoming more frequent
- They almost always focus on the same general categories: excessive fees, improper use of share class, self-dealing, and revenue sharing
- Having an independent investment fiduciary to help you make decisions regarding fees, expenses and fund changes is critical to avoid being caught in the aforementioned circumstances
- Document, review, document, review, document

How much money do you need to save for retirement? What is your "number"?...

These are two questions that continually come up at our participant education meetings. While there are many questions that have to be addressed to determine that number, there are some general rules of thumb that exist.

The "Number" as a percentage of income-

When it comes to savings, time really is money. Here's what you may need to save:

- **If you're in your 20s**: Save 10-15 percent of your income.
- **If you're in your 30s**: Save 15-25 percent of your income.
- **If you're in your early 40s**: Save 25-35 percent of your income
- **If you're 45 or older**, the percentages get really big. A 46-year-old, for example, will need to save about 40 percent of income; someone over 50 who is just starting to save will need to set aside about 60 percent of their income.

(A little bit of fine print: These guidelines assume that you'll want about 80 percent of your pre-retirement, pre-tax income once you're retired, that your retirement will last about 30 years, and that you will keep saving until the day you retire. They also assume that you're starting from scratch with no savings at all. Remember to include your company match in the percentage.)

The "Number" based on a salary factor-

Recently some financial firms have created a general formula based on your annual salary. . Benefits consultant Aon Hewitt says that by age 65 an average full-career worker needs to have banked 11 times annual pay. That means a household earning $75,000 a year would need to have saved $825,000. Work to age 67 and the multiple drops to 9.4 ($705,000); retire at age 62 and the multiple rises to 13.5 ($1 million).

The fund company T. Rowe Price advises a multiple of 12 time's final pay, while Fidelity calculates that a multiple of eight times pay will do the trick. All the firms use slightly different assumptions. But you can see that they are in the same ballpark and, more importantly, that it's a big park. In Fidelity's case they were using a 5.5% annual return and would replace 85% of after tax income for 25 years.

Please remember that "rules of thumb" are estimations and only guides: what you spend determines your nest egg needs. In retirement, the key is to make sure your "spend" is less than your "earn". Everyone's situation is different, which is why you need to think through your own case.

INSIDE THE MARKETS **FRANCIS J. DAVIES, III**

China's Great Balancing Act…

> *"For the last decade China enjoyed a delicious and fattening diet of cheesecake. This was all right for a while, but now the risk of arterial sclerosis looms, and a strict corrective regimen of broccoli is called for. It is not as tasty, but much healthier in the long run."*
> *Arthur Kroeber, GK Dragonomics*

China has enjoyed three decades of rapid economic growth. With an all powerful central government pulling the strings, this faceless monolith of manufacturing was seen as the next super-superpower, eclipsing the United States in economic power and global influence. In reality, communist China currently finds itself with the end results of rapid economic growth: slowing growth; valuation bubbles; dependence on government spending; and extreme leverage provided by a financial sector unable to learn from the past. China also has additional issues with widespread graft and a large, unregulated Shadow Banking System (SBS) which complicate any resolution. It is a matter IMCG is following closely. Deflating an economic bubble takes commitment from the top. Even in China, the government needs to calm the public.

When one considers China and its place in the global economy, it is helpful to remember history. China only emerged as a market participant in the late 1970's as economic reforms began under Deng Xiaoping. The gradual movement toward the free market has only been in place for 35 years.

China's initial surge was built upon its labor pricing advantage. As the economy grew, it gradually lost this advantage to other, poorer countries. To compensate for slowing growth in manufacturing, the government used credit and construction to fuel growth. For a country of over one billion people with little infrastructure, this made economic sense. Hospitals, bridges, railroads, factories, and entire new cities were built from the ground up. This supplied a constant stream of jobs and encouraged the Chinese migration from countryside to city. Industrial growth worked hand in hand with investment in infrastructure.

This prescription works as long as the capital is being spent efficiently. Unfortunately, there are only so many vital projects that need to be built. Providing jobs this way is a hard habit to break, particularly for local governments which play a large part in the Chinese credit bubble. They are responsible for many of the misguided infrastructure projects and much of the graft. They earn public approval by providing jobs in their districts – but no long term benefit. China is littered with ghost towns, bridges to nowhere and more steel, cement, solar panels and wind turbine production capacity than will be necessary for decades. Diminishing returns have become negative returns.

The youth of the present China can be seen in the recent government transition. In a process that began last fall, a new leadership was installed in Beijing as Xi Jinping succeeded Hu

Jintao as president in March. This is known as the Fifth Generation of government, and only the second to take office without bloodshed. The new leadership took office with a slowing economy along with an increasingly vocal population that wants clean government, a safety net and affordable housing. Balanced against those demands is the need to make progress at shifting the economy from an investment-led, industrial model to one driven more by consumers and the services sector. To accomplish this means reining in the credit markets. And that will entail short term pain.

Faced with sluggish external demand, weak domestic consumption, rising labor costs, and low productivity, so far China has done what most governments would do - whatever it takes to keep everyone happy in the short term and this economic growth model is running out of steam. The signs of possible crisis are plentiful: corporate accounts receivable have increased 20% unofficially, 13% officially; nine times the amount of commercial space sold in 2012 is now under construction; cities are no longer attracting people from the countryside; a SBS responsible for 45% of credit creation in 2012.

China's leaders worry about the impact a slowing economy may have on internal social tensions. This is a country that only recently saw only its second peaceful transfer of power – so this is a real danger. Chinese monetary policy must carefully balance the stakes in their policy gamble: either continue to bet that the short-term build-up of debt will pay off by boosting long-term growth capacity or curtail liquidity and face an angry populace. This decision is further muddled by the results of a study that showed overall life satisfaction among Chinese fell sharply in the early 1990s, bottomed out in the 2000s and has since recovered to about the same or slightly lower levels of individual happiness — despite the largest period of economic growth in history and a quadrupling of China's gross domestic product per capita. The numbers make clear that China must also address the inequity of wealth distribution.

Looking ahead, we expect China will continue to make progress in financial reform and move toward market-based interest rates. The real cause for concern in China is not the absolute debt level but the speed at which it is rising. Rapid credit expansions - as measured by debt-to-GDP - are often followed by financial crises. Dong Tao, an economist at Credit Suisse, writes that the key question is whether "the leaders in Beijing will be willing to bite the bullet and undertake more structural reforms. We do see some signs of willingness … Whether a breakthrough can be executed still remains to be seen. Until the structural issues have been addressed, we expect mediocre growth to be the new norm in China." We will also remain cautious as China faces the Catch-22 of fiscal reality vs. a population with ever heightened expectations.

IMCG NEWS

***BEN DAIGLE* –** Ben and his wife Heather added to their family on 7/26/13 with the arrival of Mason Thomas Daigle, coming in at 9 lbs. 10 oz. and 21 inches of hockey playing potential. The happy parents have had to migrate to a "man-to-man" coverage with the presence of two adorable sub-5 year olds in the house. Kennedy is anxiously awaiting her chance to play "big sister" to Mason as soon as he gets home.

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 17th 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 27th 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.

- ***The Community Schools at Opportunity Farm and Camden*** - Will host their annual "Farm to Sea" Auction on Thursday, October 3rd in The Frontier Café at Fort Andross on the river in Brunswick (www.explorefrontier.com) 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.

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).