INVESTMENT MANAGEMENT & CONSULTING GROUP

# VIEWPOINTS

4TH QUARTER 2013 ADVISORY NEWSLETTER

***20TH ANNIVERSARY EDITION***

**MARKET COMMENTARY** **FREDRIC W. WILLIAMS**

## *Sandcastles And The Incoming Tide…*

*"Even castles made of sand, fall into the sea, eventually."*
*- Jimi Hendrix*

Not to be too much of a Chicken Little after the record breaking run many of the globe's equity indices turned in last year, but we have always felt more comfortable, as the stewards to our clients' assets, being proactively cautious as opposed to running with the herd. And although we aren't anticipating a cliff-like precipice that the lemmings will blindly run over in the near term, we do think it's prudent to make sure that baseline data match the headlines when evaluating future investment decisions, lest we be surprised should Mr. Hendrix's observations become a version of reality in the capital markets.

The media's talking-heads trumpeted the stock market's out-sized gains last year, but gave scant commentary on underlying fundamentals, like relative earnings growth, that normally are the foundation upon which such advances are anchored. Corporate profits in 2013 grew in the neighborhood of 6% and were far outpaced by the 30%-plus advances in the equity indices, suggesting that other dynamics may have also been in play. Granted, there have been numerous other instances when profits and stock market growth have been out of sync, but it's always instructive to see what other forces may be driving the headline numbers. Prudent investors are those that are not blindly enamored with short term performance numbers, but instead want to understand what conditions may have propelled the gains, and if those circumstances are sustainable going forward.

*"Just as a businessman avoids investing all his capital in one concern, so wisdom would probably admonish us not to also anticipate all our happiness from one quarter alone."* *- Sigmund Freud*

As surprised as we were to stumble across the Good Doctor's commentary on the vagaries of the capital markets, our suspicion is that he could have had a bang-up business on Wall Street during the tech collapse of 2001 or the Great Recession of 2008.

So how did we get here over the course of 2013? First and foremost we have the Fed's continued monetary policy (QE1, 2, 3, 4ever, etc) which pumped liquidity into the financial system in the hope that it would stimulate the economy by keeping interest rates low for consumers and boosting lending to businesses that would create additional jobs as a result of their investments in plant and equipment. And although there was an increase in bank loan portfolios last year, the continued elevated levels of excess reserves held by financial institutions at the Fed suggests that a great deal of this liquidity merely provided a "backstop" for additional risk-on trades in the capital markets, rather than being lent out to help businesses grow.

Another source of stock market jet fuel last year the near record level of corporate repurchases of their own shares – a 40% increase from 2012 to over $500 billion, and just shy of the record set in 2007 of $589 billion. To put those staggering number in perspective, Barron's pointed out that the amount corporations invested in buy-backs could have purchased more than half the real estate and buildings in Manhattan or:

> *"...you could hoover up every team in the NFL, NBA, NHL and Major League Baseball five times over and still have enough left to tack on a little complementary network called ESPN."* *- K. Tan 1/6/14*

This leads to the possibility of a couple of dicey observations: corporations were unable to find anything better to do with their cash piles than shrink the outstanding number of their shares (which has the salutary effect of *increasing* any number of per-share ratios) and, a likely more concerning issue for the investing public, absent this magnitude of corporate largesse in 2014, how will per share earnings and revenue growth hold up, and what will be the potential impact on stock market prices?

The last leg on this retrospective stool comes from the school of behavioral economics: investor confidence. Absent any lengthy, or significant, geo-political shocks, investors ventured out of their 2008-induced bunker mode to allocate additional assets further out the risk spectrum. As noted above, with the spread between profit growth and share price appreciation expanding last year, the "culprit" was multiple expansion as investors felt more confident about paying more for every incremental dollar of earnings. At a price-earnings ratio of slightly more than 18 times earnings at the close of 2013, the S&P 500 as a whole is no longer as cheap as it was a year ago. This enhanced confidence also exhibited a bit of frothiness in terms of which types of stocks had the largest advances:

> *"...stocks that went up the most were the smallest; those with the lowest dividend yields; the highest short interest, and the worst analyst ratings. In other words, the lowest quality stocks rocked the house."*
>
> - *V. Racanelli, Barron's 1/13/14*

Our cautious optimism about the New Year is tempered by this apparent re-emergence of the "irrational exuberance" mindset that former Fed Chair Greenspan commented on in the '90s prior to the tech melt down of 2001. As we've said in the past, successful long term investing is not a sprint focused on short term returns – it's more of an incremental marathon in that contest we've always been fans of the tortoise rather than the hare. As Nobel Prize winning economist Paul Samuelson pointed out:

> *"Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas."*

All this being said, we remain constructive on global economic growth, albeit in a more muted fashion than in previous recoveries, and still believe that select opportunities exist within lagging sectors and the overlooked corners of the markets. Given our above observations, we feel that avoiding chasing the herd and adhering to the relative fundamental analysis at the core of our investment discipline will be our best guides in a potentially more volatile new year.

**EQUITY MARKET OVERVIEW** **JAY O. FLOWER**

***The Bulls Continue To Run…***

The theme for equity investors in 2013 was and may continue to be – Don't Fight the Fed. Stocks continued to surge during the fourth quarter of 2013 as the Fed's announcement that tapering would begin slowly in 2014 was met with a thunderous applause. The Dow spiked over 250 points that afternoon in mid-December and the broad indexes continued their ascent right through the close of the year. The S&P 500 was up almost 10% for the quarter and up 29.6% for the year. 2013 was the best year for the S&P 500 since 1997. As the chart below shows, the S&P 500 significantly outpaced the MSCI EAFE (Developed International) which is represented by the widely held iShares ETF symbol **EFA** and the MSCI EME (Emerging Markets) ETF symbol **EEM**.


There was a wide disparity between the performance of the ten Standard & Poors sectors as well which is typical. The top performers were Consumer Discretionary, Healthcare and Industrials ending the year up 42%, 40% and 39% respectively. Bringing up the rear were the historically more conservative, dividend-paying stocks in the Utilities and Telecom sectors up a relatively measly 11.5% and 13.2% respectively. Benefiting index investors was the fact that the Utilities (2.9%) and Telecom (2.3%) sectors represent the smallest weightings in the S&P 500.

While the year had plenty of disturbances and reasons for concern (both required for a bull market to maintain momentum) the economy, by virtually all indicators, showed continued improvement. Unemployment fell to 7% for the first time since '07, home prices continued to rise along with the construction of new homes, consumer spending finally increased and household wealth adjusted for inflation increased all four quarters of the year. A steady stream of positive quarterly earnings reports coupled with conservative yet optimistic forecasts helped keep the momentum going in the broad indexes.

The question now is whether or not the market is overvalued. There are plenty of metrics available to use to try and determine this elusive data point. Operating earnings is one we will use for arguments sake here. The consensus estimate for 2013 operating earnings on the S&P 500 is roughly $106/share. With the index closing the year at 1848 the index is selling at just over 17 times trailing earnings this level is still about 10% below the average when long term rates are below 8%. Also, corporate earnings are up over 10% this year while GDP is only up about 2%. If the economy continues to improve along with corporate earnings it is reasonable, we believe, to expect the upward momentum in the equity markets to continue albeit not without temporary interruptions nor at 30% every year.

| **Table 1 - Index Returns** | | | |
|---|---|---|---|
| **Equities** | *Percentage Change for the 4th Quarter* | *Percentage Change for the Year* | *Annualized 10-Year Returns* |
| S&P 500 | **10.51%** | 32.39% | 7.41% |
| DJ UBS Commodity Index | **(-1.06%)** | (-9.52%) | 0.87% |
| MSCI EAFA | **5.71%** | 22.78% | 6.91% |
| MSCI EM | **3.46%** | (-3.70%) | 10.47% |
| NAREIT Equity REIT Index | **(-1.34%)** | (-0.53%) | 8.54% |
| **Fixed Income** | | | |
| Barclays Aggregate | **(-0.14%)** | (-2.02%) | 4.55% |
| Barclays U.S. Treasuries | **(-0.75%)** | (-2.75%) | 4.23% |

## BOND MARKET OVERVIEW — JASON E. FOSTER

***The Song Remains the Same…Almost…***

In the final quarter of the year, the long end of the yield curve continued its trend upward, the Fed's widely expected tapering announcement finally arrived, and we as fixed income investors, were left looking ahead at the new year just as we did the last, with few attractive options.

Like most of the year, performance among the fixed income sectors were mixed. More signals that the U.S. economy continued to heal was a double edged sword, padding the performance of credit sensitive high yield bonds while interest rate sensitive bonds like U.S. Treasuries as measured by the Barclays Capital U.S. Treasury, index slid another -.80%. For the year, the disparity in returns between the best and worst asset classes was dramatic. High yield bonds closed out 2013 with a return of +7.4%, while the Barclays Capital TIPs benchmark lost -8.6%, a spread of 16%. In fact, junk bonds were one of the only bond types to finish with positive results for the year (see table below):

| Fixed Income Benchmarks* | 2013 Returns |
|---|---|
| Barclays US Aggregate (Broad Market) | -2.02% |
| Muni Bond Index | -2.17% |
| 10-Year Treasury | -7.81% |
| Treasury Inflation-Protected Securities (TIPS) | -8.61% |
| Floating Rate (Barclays FRN BBB) | +2.42% |
| High Yield (Corporate HY Index) | +7.44% |

***Information provided by JP Morgan Asset Management**

One signal that the economy was improving occurred on December 18th, when Ben Bernanke finally announced that "tapering" was on, and the Federal Reserve laid out its plan to gradually trim the bond purchases. The first phase would be a reduction from $80 billion to $70 billion a month, a path clearly designed to keep investors at ease. His hedged message was clearly effective as fixed income markets took the news in stride with treasury rates rising only modestly after the news. In fact, when looking at the 40 basis point climb in the Ten-year treasury rate during the quarter, the majority happened well before the announcement, a sign the markets were clearly expecting the decision. But like the old saying goes, "buy the rumor, sell the news".

As we assess the fixed income landscape for 2014 we find ourselves in much the same predicament as the start to last year. Short term interest rates remain in the basement. Money markets barely pay above 0%, while short-term investment grade paper, whether treasuries, CDs, or even corporate bonds still dish out anemic yields. The year did provide some relief with rates improving on longer maturities; take for example the ten-year treasury. According to the Department of the US Treasury the Ten-year treasury paid 1.86% the first week of 2013, and by Dec 31st was paying 3.04%. The Twenty- year jumped from 2.63% to 3.72%. Yet, while more enticing a 3.04% yield poses little threat to the equity alternative. Where we continue to see value for our clients who need bonds, as we pointed out mid-summer, is in the municipal bond market. Price adjustments in this space have created an opportunity to selectively choose quality municipal bonds that offer compelling after-tax tax returns, when compared to other investment grade taxable alternatives. How long this window remains open is unknown, but we will exploit it until it closes.

## FIDUCIARY CORNER — STEPHEN L. EDDY

### *Game Changer?...*

One of our constant focuses as investment fiduciaries for retirement plans revolves around investment expenses, platform costs, and plan fees in general. The reason we are so adamant about managing this aspect of our clients' plans is that fees impact performance: the lower the fee, the better the performance; the better the performance, the more money for participant retirement balances. Even Morningstar admitted last year that based on an internal study they commissioned, lower expense ratios and investment costs were more indicative of fund performance than their highly visible "star" ratings. It's the primary reason we contractually cap our retirement plan fees when they reach certain thresholds.

Recently, a 401(k) platform came out with a new pricing strategy for administering 401(k) plans. Since this type of product “announcement” literally occurs several times a quarter from the myriad of 401(k) platform vendors, it shouldn’t be a big deal. We usually review these announcements, determine whether they are of real value to our clients or just marketing, and usually move on. This one however caught our attention.

Vanguard, the high-quality, low cost mutual fund and ETF provider, is recommitting to the administrative side of the business and pricing it in a way that is unique to mutual fund platforms: all they charge is a per participant fee. This may seem innocuous, but in reality every other fund platform charges an asset based administrative fee, or a hybrid with a little bit of both. While the Vanguard pricing system isn’t the least expensive (they have a partnership with third party administrator Ascensus to deliver this new service), it IS innovative.

What it means for retirement plans is simple: fixed, predictable costs. You simply pay based on how many participants you have. Since 2012, when the judge in the Tussey v. ABB case called out Fidelity for charging the same asset-based fee at $1 billion that it charged at $500 million (with, as she observed, no commensurate increase in service), we have been waiting for a platform to address this issue. Vanguard has, by providing access to unlimited open architecture institutional share class funds from almost every family, all for a per participant fee. As the table below shows, this is good news for the long-term company with the stable employee population.

| Year with Platform | # of Participants | Plan Assets | Vanguard Per Participant Cost | Competitor Asset Based Platform Cost (24bps) |
|---|---|---|---|---|
| **Year 1*** | **100** | **$5,000,000** | **$11,100** | **$12,000** |
| **Year 5** | **120** | **$10,000000** | **$10,900** | **$24,000** |
| **Year 10** | **150** | **$15,000,000** | **$12,850** | **$36,000** |

* - includes $1500 conversion fee for Vanguard (usually waived on other platforms)

As you can see, the very common scenario shown reflects significant asset growth and moderate participant growth. Assuming use of the same funds on each platform, it is very clear that the Vanguard platform is much less expensive for the typical plan. It is why we consider this model to be a potential game changer. The proof will be in Ascensus’ ability to service the model because the pricing is already best-in-class.

## PLANNING CONCEPTS — TRACY ROGERS

### *Paying for college*

As people are preparing for filing taxes once again, many are also compiling their data for FAFSA (Free Application for Federal Student Aid). I thought this would be a good time to revisit a topic from a few years back. Applying for college seems like a full time job nowadays, between the extracurricular activities, asking for recommendation letters, writing essays, studying for the SAT’s and visiting schools. Unfortunately, it probably feels like another full time job is needed just to pay for school.

*No Loan Colleges:*

Most schools give some scholarships and financial aid, but not always enough to make the school affordable. There are a number of schools, however, that commit to meeting 100% of all admitted students' demonstrated financial need.

But what does that mean? If College X looks at Peyton's financial information and determines that his family can afford to pay $20,000 that year for college, then the school will meet the difference with financial aid. A school that costs $50,000 a year but doesn't meet 100% of demonstrated need may calculate that Peyton's family can afford to pay $20,000 but the school only offers $20,000 in grants, scholarships, and loans, which leaves Peyton's family with an unmet need of $10,000.

Loans do not count as financial aid. If a college meets your full demonstrated need but does so using a significant amount of loans, the school may not be a financial fit for you. Colleges that meet 100% of demonstrated need without loans don't bar students and their families from taking out loans, but only have them do so if they need help paying the family's calculated contribution.

Each college uses its own formula for calculating financial need. It is entirely possible that College X could calculate your family's estimated financial contribution (EFC) to be $25,000 and another could calculate it to be $14,000. This is one reason why many students like to apply to a variety of schools and compare financial aid packages.

*Types of No-Loans Policies:*

The policies fall into four main types:

- **No loans.** These policies eliminate loans from the financial aid package of low income students. In Princeton's case, the loans are eliminated from the aid packages of all students, not just low income students. Other schools with no loan policies for low income students include Rice University, and the University of Virginia.
- **Loan caps.** These policies institute a low cap on student loans for low-income students. Examples of schools with such policies include Brown University.
- **No parental contribution.** These policies eliminate the parental contribution, but retain the student contribution along with the standard self-help level. These policies may still require some loans in the aid package, albeit a reduced amount. Examples of schools with such policies include Yale and Stanford.
- **Pell grant match.** These policies match the student's Federal Pell Grant. This significantly reduces but does not eliminate the self-help level. Examples of schools with such policies include MIT and previously included the University of Minnesota system.

Below you'll find a list of schools that meet 100% of demonstrated need for domestic students with grants and scholarships alone between all incomes and income adjusted. This is by no means a complete list but rather an introduction to raise awareness of this for our clients.

**100% of Need without Loans for All Incomes:**

Amherst College; Bowdoin College; Claremont McKenna College; Colby College; Columbia University; Davidson College; Harvard University; Haverford College; Pomona College; Princeton University; Stanford University; Swarthmore College; University of Pennsylvania; Vanderbilt University; Washington and Lee University; and Yale University.

**100% of Need without Loans for Some Incomes**

Brown University - < $100,000; Connecticut College - < $50,000; Cornell University - < $75,000; Dartmouth College - < $100,000; Duke University - < $40,000; Lafayette College - < $50,000; Lehigh University - < $50,000; MIT - < $75,000; Northwestern University – Pell Grant Recipient; Rice University - < $80,000; Vassar College - < $60,000; University of Chicago - < $75,000; University of Virginia - < 200% of Fed Poverty; Washington University of St. Louis - < $60,000; Wellesley College - < $60,000; and Wesleyan University - < $40,000.

Granted, getting into some of these schools is extremely difficult. I wanted to highlight this topic once again since many students and parents don't apply because of cost. Many are unaware that some colleges have "no loan" programs.

There are numerous resources that are continually updated on this topic.

www.finaid.org
www.projectonstudentdebt.org
www.collegexpress.com

Hopefully, going through this analysis with your college applicants will help you make the best decision before they are off to college. Please call if you need to discuss in more detail.

## INSIDE THE MARKETS — FRANCIS J. DAVIES, III

***Research Process Enhancements…***

The goal of stock selection is to find stocks that will provide the best return while minimizing risk. IMCG relies on traditional, accounting-based performance measures to find companies with a market price below what we believe to be the real worth of their business and then profit when the market realizes the value. This approach has served us well, but we need to adapt to current circumstances. Earnings can be managed with indecipherable accounting practices and fixation on short term results is often inconsistent with building shareholder value.

We need to go deeper into earnings statements and balance sheets. Timely analysis of the amount of data necessary in this process would be an imposing task without a partner, so we have teamed up with Applied Finance Group, a Chicago based research firm that will provide us with quantitative analysis. By examining cash flow down to line item accounting, we can identify those companies that are earning a return greater than the cost of capital. This metric is what business consulting firms study endlessly and is what they emphasize at business schools.

Allocation of resources is crucial to the creation of shareholder value. The largest consulting firm in the world, Deloitte, determined that earnings growth alone is not sufficient to drive sustainable shareholder value. Lasting value is only created when increased earnings are balanced with efficient use of assets. AFG has developed a framework that quantifies these variables into a measure they call the Economic Margin (EM).

EM evaluates corporate performance from an economic cash flow perspective, weighing the return a company earns above or below its cost of capital and provides a detailed view of a company's underlying economic vitality. It is a multi-dimensional metric, which ties together revenue, cost, and asset efficiency. It addresses the four main drivers of enterprise value: profitability, competition, growth and cost of capital. Competition is not factored into traditional analysis. In the real world, large margins attract competition. EM accounts for this by gradually eliminating the excess spread a firm generates above or below its cost of capital.

The connection between EM and shareholder value is undeniable. Deloitte has shown that it has greater influence on shareholder value than earnings growth or revenue growth. It has a proven track record of consistently identifying companies trading above or below their intrinsic valuations across sectors, market capitalization groups, and growth/value universes.

A real life example of EM generation is seen in how companies reacted to the recession. Companies that respond to economic challenges in knee-jerk fashion - closing plants, laying off employees and slashing budgets - may improve their short-term earnings and gain short-term approval from Wall Street. But short-term earnings growth does not reliably generate lasting shareholder value. The companies that not only survived, but thrived in the longer term, kept many parts of their business in balance by taking actions that not only improved their profit and loss statements, but also their balance sheets. They took a holistic approach that drove up overall enterprise productivity through simultaneous improvements to operating margins and asset efficiency. Those are the companies IMCG seeks to find. Our cutting edge research is another tool we use in that pursuit.

## IMCG NEWS

***20th Anniversary* –** January 2014 marks the 20 years since IMCG was founded, so we'd like to thank our clients, colleagues and staff for our continued success. From our initial offices on Exchange Street we've grown to a firm offering portfolio management and financial counsel for individuals and families, as well as fiduciary consulting for endowments and corporate retirement plans.

***Mary Emmi*** - We are pleased to announce that Mary has joined our Client Development & Support Group, and will be teamed with Camille Shiffler and Jeannine Plourde providing our clients with superior administrative and operational service. A University of Maine at Orono graduate, Mary joins us having been a legal researcher within the State court system, and resides in Portland.

***Tom Donaldson* –** Returning to the firm that he helped found, Tom joins IMCG as a Senior Advisor to our Investment Policy Committee, with a focus on both the energy and small cap space, as well as continuing to serve as a Portfolio Manager. Tom began his career with Tucker Anthony in Washington DC, moving to Maine as one of their Senior Vice Presidents in 1986. He then worked as a First Vice President for Prudential-Bache in Portland before joining Fred Williams to found IMCG in 1994. Tom became the Senior Vice President and Trust Officer at Androscoggin Savings Bank in 1997, retiring from that in 2002, although continuing to be active in the advisory business as the Principal for Portfolio Management Consulting in Falmouth. Tom's education incudes degrees from Brown University (B.A.) and The University of Texas (B.S.) and the Small Business Management Program at Harvard University.

***IMCG's Business Open House*** – This year's event featured a "Chicago-Style Stuff the Ballot Box" benefit for a number of local charities that IMCG either works with professionally or has employees volunteering for. Between our guests' contributions and IMCG's match, more than $4,000.00 was provided to the following organizations: Wayfinder Schools (www.wayfinderschools.org), Center for Grieving Children (www.cgcmaine.org), Big Brothers Big Sisters (www.somebigs.org), The Dream Factory (www.dreamfactoryincmep.org), Preble Street Resource Center (www.preblestreet.org), and Stepping Stones (www.steppingstonesusa.org). We thank everyone who donated to their favorite organizations!

***WEB SITE*** – We've added new pictures, newsletters and a client log-in portal, (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).