



## VIEWPOINTS

2<sup>ND</sup> QUARTER 2005

ADVISORY NEWSLETTER

MARKET COMMENTARY

FREDRIC W. WILLIAMS

### *Things That Go Bump In The Night: Housing and China*

Having reached the mid-point in the year, a look back at the 2<sup>nd</sup> quarter of 2005 shows many of the same themes and concerns once again at the forefront as we enter the holiday break that traditionally demarcates the hazy, lazy days of summer. From increases in short term interest rates, to oil prices, our current account deficit and the omnipresent threat of terror-related geopolitical events, the most recent quarter has seemed to be a continuation of the first with the domestic capital markets bracketed by a trading band, albeit a lower one, amid a modestly rising chorus of concerns about what the eventual impact that China's growth and our domestic real estate bubble might have on our economic state of affairs. Both of these situations offer insights into how our global economy got to this point, as well as potential lessons in how one might not want to value or measure "progress" in the developed and emerging worlds. As Stephen Roach from Morgan Stanley observes:

*"...As China transitions from a state owned to a market based system, it must undertake a daunting transformation in its approach to economic policy: The administrative measures of its central planning heritage will need to give way to the more powerful but blunt instruments of fiscal, monetary and currency policy...Chinese policy makers are still operating with a central-planning mindset...More than a year into the current tightening campaign, and interest rates have only been raised 27 basis points; over that same period, there has been no shift to fiscal restraint and no change in currency policy. Moreover, the limited increase in interest rates stands out all the more in the context of a 200 bp monetary tightening in the US; China's dollar-based currency peg suggests that a good deal more of the recent Fed tightening should have been matched by the People's Bank of China..." 6/17/2005*

And what are the implications for seemingly "foreign" policy structure in our ever more globally linked financial world? To date, our trade deficit with China has primarily resulted in the recycling of our dollars back to our capital markets via the P.B.C.'s ongoing purchase of our Treasury bonds, helping keep interest rates low and thereby fueling our domestic real estate bubble. Of late, we're starting to see these dollars return to our shores in the form of equity based acquisitions. Prime examples of this are Lenovo's purchase of IBM's PC division, and the recent offers for Unocal and Maytag, to name a few. In the 1980s, we were concerned about Japan's efficient and savings-oriented society buying everything "American" – it appears now that our new Asian fear is the Chinese cache of dollars, sent

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there by our own consumer driven economy, and the possibility that they might have the same "buy American" agenda at the beginning of the 21<sup>st</sup> century.

It was no surprise that Greenspan & Company provided two more 25 basis point increases in interest rates during the quarter, along with continued commentary suggesting they were yet to be finished with the tightening trend they initiated last year. With the Fed Funds rate now at 3.25% what is surprising is that we aren't seeing a corresponding rise in the long end of the market...yet. The 10-year Treasury ended the quarter at 3.922%, and the once dormant 30-year was only marginally higher at 4.3%, drawing a fairly flat yield curve given the regular increases we've seen at the short end of the market. Additionally, despite the widespread perception that rates are headed higher, it was the domestic bond market that has been the only bright spot here at home as the 10-year T-Note has provided a year to date total return of 4.14%.

In the face of all this noise, our equity markets continued to be underwater for the year, with the Dow down another 2.18% in the quarter, leaving it off 4.7% thus far this year. Although the S&P 500 rallied 0.91% and the NASDAQ was up 2.9%, both remain in negative territory for the year at -1.7% and -5.4%, respectively. Given the issues with oil, interest rates, and jobs, our sense is that the bounce we've seen in S&P and NASDAQ is nothing more than a resurfacing of some of the speculative froth from the end of last year's run in the markets – we're once again starting to hear about tips from "the cab driver of a friend's dentist whose hair stylist overheard a conversation at a bar in Toledo" as being a basis for investing in equities...all of which sounds eerily reminiscent of the late 1990s. Once again the bright spot for domestic equities was the Dow Jones Utilities Average – up 15.42% year to date, and a remarkable 40.25% over the last 52 weeks. We have always been fans of equity-tortoises (like gas/water/electric utilities) given their traditional dividend yields and fairly predictable growth over time. Whether from interest or dividends, we are fans of cash flow compounding within investment portfolios, thinking that it is, in fact, the eighth wonder of the world. That being said, it's starting to look like everybody else has found our party and prices are getting a tad elevated for this fairly staid group, leading us to consider harvesting some of our gains and seeking additional values elsewhere.

Again this quarter and despite a rally in the dollar, the overseas markets were the place to be as positive returns in local currencies ranged from 6.2% with the FTSE-100 in London, to 10.7% with France's CAC-40, 7.8% in Frankfurt's Xetra-DAX and 5.6% at Australia's ASX. Returns were more modest in Asia proper with the Nikkei up 0.8% and the Hang Seng off by 0.2%, as the export driven economies wrestled with surplus trade dollars and a concern about the longevity of the U.S. consumer's buying if there were a global slow down, or if the currency translation became less that favorable. Despite the recent strength in the dollar, it appears that Europe has the opportunity for a restructuring advantage assuming they continue to make progress with the unions and the social welfare approach to capitalism:

*"I continue to feel that the angst over Europe's political disappointments is obscuring the meaningful progress being made on structural reform...Labor market rigidities are improving at the margin – underscored by progress in Germany, where shortened workweeks are being abolished, labor unions are losing their industry-wide bargaining power, and the rapid growth of part-time and temporary*

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*workers is creating a more flexible workforce. Equally encouraging, in my view, is Corporate Europe's recent push into IT-enabled capital spending – a belated but nevertheless encouraging catch-up to the trend first established by the US in the late 1990s.” Stephen Roach 7/1/2005*

Here at home we continue to be in the throes of a real estate bubble. The dollars that left the equity markets over the last few years are showing up, with the assistance of Fed-induced low cost (at this point in time) leverage, in a building and price escalation boom. In addition, we've seen a transformation in domestic savings whereby a significant portion of our population looks at their home as a piggy bank, taking advantage of various low interest and reduced payment loans to extract cash that often times becomes consumable income. The concern is not only the future costs, as in eventual debt repayments, that are showing up on our personal balance sheets but a genuine question of supply and demand:

*“Last year we built 2 million new homes. Yet we added only 1.2 million new households. That means we absorbed about 800,000 homes either as second homes or for investments. Given various studies, it is probable that around 500,000 homes were bought for investment over and above the number of new households... That is a major part of the bubble. If new homes were rising in line with the growth in households, there would not be the potential for supply to outstrip demand. When, not if, we enter a recession with a significant overlap of excess supply while unemployment is rising, that could cause a sharp break in housing values in certain areas.” John Mauldin, 7/1/2005*

Much like the tech bubble of the late 1990s, this supply and demand imbalance is compounded by a set of expectations that remind one of the “new paradigm – it's different this time” mantra that we heard to justify those unheard of equity valuations:

*“But investors are nothing if not optimistic. The LA Times, in a recent survey, reports that local homeowners expect to see housing prices rise by 22% annually for the next ten years. Now this is a group, while admirably optimistic, that clearly didn't pay attention in math class. Compounding at 22% a year for ten years is an 800% appreciation, doubling every 3.27 years. 22% doesn't sound like much. Let's just project today into the long term future. Not doing the math, they do not realize that means homes would have to go up in value 8 times! But such is the nature of bubbles. That is why it is called "irrational exuberance." Front Line Thoughts – 7/1/2005*

And add to that the more national scope of this mania and the precariously high debt levels being secured by this asset, and it's clear that there is not much margin for error in this sector...unless real estate prices just continue to rise forever. As Gary Shilling writes:

*"...The national scope of the housing bubble is no surprise given its driving forces. They aren't local economic booms. Indeed, there's nothing anywhere in the country today to rival the oil patch boom in the 1970s, the Cold War aerospace spending jump in the late 1980s or the dot com bubble of the late 1990s. Instead, the driving forces, discussed earlier, are national-- the appeal of real estate as an alternative to stocks and low interest rates. And lax lending standards. The leap in subprime loans from 9% of total mortgage originations in 2003 to 20% last year, according to the FDIC, is telling. So are the high loan-to-value, interest-only and option ARMs mortgages [enticements to reduce near term payments and qualify more people for loans]"*

Obviously, to keep this bubble alive, there will need to be a continual stream of buyers willing to pay ever increasing sums for their shelter. And this would seem to require the foundation of a growing economy providing ample employment opportunities replete with

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escalating income streams. As you can imagine, our Nirvana-like description of the perfect Goldilocks economy is not something our relatively jobless recovery has been able to deliver thus far. All of which makes us cautious about the near term, particularly when some of the "numbers" don't seem to make sense:

*"Sometimes perusing the handiwork of this nation's worthy number-crunchers we get the feeling we're not in the good ol' USA but in the Soviet Union, circa 1970. Strange sensation, indeed, and we trust we're not impugning anyone's integrity or diligence or anything like that. As we say, it's just an aberrational feeling...We experienced it again last week on receipt from some eagle-eyed readers of the results of their close reading of the final version of first-quarter GDP, as revised by the Bureau of Economic Analysis (the BEA, as it's known to friend and foe). The figure was 3.8%, up nicely from the preliminary estimate of 3.5% and sharply better than the advance reckoning of 3.1%. The improvement was hailed by the usual hailers and gave stock prices a brief boost...The difference between the 3.5% preliminary rise reported for GDP and the final 3.8% released last week is, even by our shaky math, 0.3%. As it happens, that also was pretty much the amount by which the official inflation measure -- the GDP implicit price deflator -- was revised downward, to 2.89%, from 3.16%. OK? What caused the big drop in inflation and hence the rise in GDP was ...housing. We kid you not. According to the BEA, housing prices, which they figure rose at 5.4%, 9.1%, 6.8% and 3.8% annual rates, respectively, in the last four quarters of '04, fell to a 1.1% rate in the first quarter of '05. Funny, we had the impression that housing in January-March was on fire, and prices more than rising apace...Not so, say the lads and lassies at the BEA. They do concede that spending on housing was up a robust 11.5% in the quarter. But prices were up a meager 1.1%. Come on, comrade, tell us another. Or better yet, tell anyone who bought or sold a house in the first quarter: The buyers, anyway, could use a good laugh."*

Given this environment, we will continue to allocate assets to generate cash flow, hedge against rising interest rates and a declining dollar, all the while maintaining a sufficient cash position to take advantage of opportunities that arise from our research and valuation analysis.

#### **WEALTH MANAGEMENT UPDATE**

CHARLES W. DIBNER, CFP

Why a need for financial planning? Well, quite simply, for three reasons:

1. It is logical, personal and makes sense.
2. It is consistent and builds upon itself
3. It has to do only with *YOU* and *your needs*.

The public media has besieged us, over the past few years, with charts, graphs and articles that tell us how an average person, say, between the ages of 40 and 60, should invest their assets. The designated solutions involve terminology and suggestions that are expressed, usually, in the most technical of language. If one understands it, one realizes that this entire methodology has little to do with your personal financial situation. The designated solutions can not analyze, evaluate, recommend nor follow up on any investment recommendations. They cannot be flexible and responsive to your needs or changing life situations.

The following is a short and, admittedly, very incomplete overview of what our offices work on and help resolve in a typical given work week:

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- New clients, data gathering, organization, analysis, calculation, proposed resolutions, prioritization of focus.
- Estate planning: advising on wills, probate, trusts, passage of assets to heirs, protecting assets, ownership changes, estate tax liability, special needs trust, family discussions, health care documentation, the problems with aging.
- Investing: monitoring, researching, evaluating, buying/selling, strategizing, negotiating, and keeping up to date on the world.
- Real estate purchases and sales, unusual Trust arrangements, specialized projects, trusteeship responsibilities, new legislation, ownerships, taxation, passage to heirs, civic involvements.
- Divorces, contract advisement, marriages, deaths, special projects with lawyers, valuations, testifying in court,
- Setting up specialized college and travel accounts, producing client income on a regular basis, reducing income taxation, retirement plans, business advice.
- Risk management and every kind of insurance analysis known to humankind
- Advice on education planning, finding tuition money, foreign students, living in foreign countries, currencies
- Advising on major purchases, computer systems, vacation homes, investment properties, long-term care.
- Education, education, education for both you and your children

So, what does a “Wealth Management” or “Financial Planning” office actually do? There are two distinct approaches: The first is to intake client data and to produce a written document called a “Financial Plan.” This plan lays out their analysis, proposed solutions and views of what you need to do to attain certain goals. Many offices will then, for a fee or commission, do investing for you.

The second is to treat the client relationship as a multifaceted whole, intake and produce a prioritized analysis and plan, put money to work to serve personal needs, investment or otherwise, and continue to provide counsel, no matter what the subject, as part of the contract.

We are the latter.

## **THE NEED FOR ESTATE PLANNING**

TRACY W. ROGERS

Sometimes in our busy lives, people let their priorities shift to items that are more immediate, at the expense of a view of the future. This seems to be the case for estate planning and the updating of the plan and its documents when changes occur. To this end, over the next few newsletters, I will be touching on some basics of the estate planning process. Though many of our clients have already had this done, there may have been life changes, or changes to the law, that would necessitate a review and possible modification. Our thoughts are that these topics are designed to be a high level glance at estate planning and may or may not have relevance to your particular situation. If these articles make you think or take action on something that has not been done, then they have accomplished their goal.

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At a person's demise, there are certain typical problems, which, if not planned for, can create a burden for those left behind. Proper estate planning can help eliminate, or at least reduce, these challenges.

### **Financial Burdens**

Estate settlement costs could be too high – these costs consist primarily of probate fees and death taxes:

- Probate fees: These are generally paid to executor and the attorney who assists with the probate court process.
- Death taxes: Estates that exceed certain amounts may be subject to both state and federal taxes.

Estate assets are improperly arranged:

- Liquidity: There may not be enough liquid (cash type) assets to pay estate settlement costs.
- Cash flow: There is not enough income to care for the love ones left behind; e.g., spouse and minor children.

### **Transfer of Assets**

- Estate assets may be subject to probate delays or expense
- Assets transferred to minors may be in cumbersome guardianship accounts until the attain age of majority and then are distributed outright.
- Additional death taxes may be paid because there was no pre-death planning.

### **Care of Minors**

- Guardians: Proper planning can eliminate the appointment of guardianship by the state.
- Asset management: If the wrong persons are chosen to manage the assets left for the minors, the assets may be lost or unnecessarily reduced.

So again, has anything changed in your lives that warrant an update?

### **IMCG NEWS**

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We're pleased to announce a new member to the IMCG Team, as well as an update on the summer's construction calendar:

**RENEÉ NGUYEN** – The newest member of the IMCG's Client Management Team, as well as a new mother, Reneé joins us from Bank of America's Private Advisory Services. She will be an integral part of our new structure and we look forward to her working with her colleagues and meeting all of the firm's clients.

**RENOVATIONS AND EXPANSION** – As mentioned in our last issue, please excuse our building and offices when visiting for consultations. As we write this the 1<sup>st</sup> floor lobby is in the midst of being renovated to match the rest of the building; so thereafter we will be expanding our space on the top floor given our ongoing expansion. We expect to have the office reconstruction completed by Labor Day.

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