



VIEWPOINTS

3RD QUARTER 2005

ADVISORY NEWSLETTER

MARKET COMMENTARY

FREDRIC W. WILLIAMS

Kat-Rita...

The obvious, and unfortunate, story of the quarter is the devastation of the central Gulf Coast from Hurricanes Katrina and Rita, and the impact these events may have going forward. In addition to the lives lost and the families dislocated from their homes, some focus has been on the constraints placed on our nation's refining capacity, along with our ability to import raw materials for manufacturing, as well as export agricultural products through the Port of New Orleans. Fortunately Rita came ashore as a lesser magnitude storm, sparing lives and personal property from a Katrina-like repeat, although it none the less had a more severe impact on the oil rigs off the coasts of Texas and Louisiana. Regardless as to the intensity, there will be an impact from these weather related events; the questions will merely surround their extent and duration.

Whether the battering Florida took last year and the record number of Atlantic storms (20 as we go to press) this year are in any way correlated to global warming trends will be actively debated by both weather watchers and politicians (the latter contributing significantly to the hot air that feed these tropical depressions). Many meteorological historians have cautioned against the risks of weather related complacency as we in the US have continued to aggressively develop coastal areas, particularly in the southeast, despite the regular appearances in the past of category five storms that have leveled broad swaths of the southeast, much like Katrina did. In an ironic twist, rising insurance rates, when combined with rising interest rates, may create the catalyst to curtail the excessive development that would be exposed to the risks of natural disaster; this could thereby provide an ancillary benefit of slowing the bubble- like pace of the overall Gulf Coast real estate market.

The genesis of the torrid rate of growth in asset valuations, as well as the US consumer's inclination to spend at a rate in excess of their earned wages, has been the extremely low rates of interest that have fostered borrowing, rather than saving, to buy assets. From real estate, to cars, to companies and investments, the bidding to buy has been spurred on by a low cost of capital. As we saw with margin loan rates in the 90's, the offshoot of this type of an environment can be bubble pricing attached (perhaps temporarily) to purchased assets where "pricing" is a function of demand and not value – we saw this in technology stocks and there's a good chance we're seeing the same thing in some elements of the real estate market.

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The propensity for this level of borrowing is fueled by investor complacency and the blind acceptance of higher asset prices without requiring the commensurate higher risk premiums in the pricing. As Fed Chairman Greenspan pointed out in his most recent “watch out” commentary:

“Thus, this vast increase in the market value of asset claims is in part the indirect result of investors accepting lower compensation for risk. Such an increase in market value is too often viewed by market participants as structural and permanent. To some extent, those higher values may be reflecting the increased flexibility and resilience of our economy. But what they perceive as newly abundant liquidity can readily disappear. Any onset of increased investor caution elevates risk premiums and, as a consequence, lowers asset values and promotes the liquidation of the debt that supported higher asset prices. This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums.” August 26, 2005

Given the breadth of the housing market in our economy, our concern focuses on the impact that any erosion in real estate values could have on consumption – something that has been both the lynchpin of our domestic GDP, as well as the engine for recycling dollars through our trade deficit and back into our debt via government bonds. Much like the recession we saw after the technology bubble decimated so many artificially inflated 401(k) plans earlier this decade, we see the potential for a similar economic impact if housing prices don’t continue the rate of growth that real estate owners have come to rely on to fund their home equity loan purchases.

With Consumer Confidence slipping in September, along with a decline in personal income (off 0.1% in September), it would appear that a slowing GDP (3.8% in Q1; 3.3% in Q2; with Q3 estimated at 3.5% and Q4 at 3.0%) is in the cards. Throw into the mix rising inflation (the CPI increased 0.5% last month) along with an eventual global current account adjustment that will inevitably push domestic interest rates higher, and you have a recipe for modest growth and mediocre capital markets performance...just the kind of environment one can find value in while those around you are acting emotionally, rather than with a longer term view.

EQUITY MARKET OVERVIEW

INVESTMENT POLICY COMMITTEE

Trading Range...

The domestic equity markets ended the third quarter of 2005 fairly close to where they started the year, further extending the approximate 5% trading band that started late in 2004. Energy, interest rates, geopolitical developments and the domestic economy continued to be the driving themes that bracketed the indices throughout the summer – from the spike in oil prices, to increasing short term interest rates, the war on terrorism and the apparent slowing in G.D.P. growth, stock market participants had a more than sufficient “wall of worry” to climb during Q3.

Stateside we saw the Dow Industrials rise by 2.8%, leaving it down 1.99% for the year to date, while the S&P 500 climbed 3.1% (off 1.48% YTD) and the NASDAQ was up 4.6%

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(-1.09% since the start of the year). Like the last two quarters the real action was overseas, where lower valuations, along with favorable currency exchanges, supported upside movement almost across the developed and emerging landscape. The only notable exceptions were Venezuela, where Castro-wannabe Chavez continues to cause problems, and China/Taiwan, where currency and political issues converged to let a little air out of the bubble. Elsewhere, Tokyo's Nikkei closed the 3rd quarter up 18.15% for the year, Frankfurt's Xetra DAX finished up 18.52% year to date, London's FTSE is up 13.78% and the Paris CAC is ahead 20.38%.

Internationally the markets appear to be driven in part by an increased demand from US investors to diversify their holdings away from a solely American-centric structure, to one that includes other currencies and companies, thereby mitigating single company and single country risk. With Japan hitting a string of 4 year highs at the close of the quarter, and the Dow Jones Stoxx 600 [a broad measure of the largest pan-European companies] up 18% in local currency terms, despite reduced equity demand on the continent, investors who shunned global diversity in the '90s are now recognizing the benefits to both return *and* risk from more broadly based holdings.

Domestically, other than the Dow Utilities which climbed 10.86% for the quarter and stand up 29.09% for the year, the markets began to look frothy with resurrected internet and brokerage stocks leading the way. Given the fragile underpinnings to our slowing economy, it's difficult to rationalize (once again...) paying a half century's earnings (i.e. a price earnings ratio of 50) for any investment, be it the stock *or* real estate market. Although we feel there are pockets of value within the markets, we would prefer to err on the side of caution and not find ourselves surrounded by a chorus of day traders uttering Yogi-isms like: "*It's déjà vu all over again*". We're happy with low relative valuations and dividend cash flow – we don't need to be tilting at windmills, either real or imagined.

BOND MARKET OVERVIEW

INVESTMENT POLICY COMMITTEE

Flattening Yield Curve...

The Federal Open Market Committee (FOMC) made it eleven quarters in a row at their September meeting, once again following their "measured approach" and increasing the federal funds rate by 25 basis points (¼%). This preserved their streak, dating from June of 2004, in which the Fed has pushed short term rates up from 1% to 3¾% in an attempt to contain any whiff of inflation, while still allowing the economy to expand given the ongoing low real rates of interest. Although Mr. Greenspan has had an accomplice (rising energy prices) in his quest to exit the Fed Chairman's stage in February of 2006 with a stellar record, he's been frustrated by the fact that long term rates have actually come down as he and his pals pushed up from below. Not only has this continued to close the gap between short and long term rates across the yield curve, but it has also fed the housing bubble that he has been warning about the last few quarters.

The 10 year Treasury note closed the quarter yielding 4.33%, while the 30 year Treasury bond traded at 4.57%, providing less than 25 basis points for 20 additional years of maturity, which, to us, doesn't sound like reasonable compensation in an environment of rising energy

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prices, to say nothing of other inflationary pressures. With the US savings rate at -.7% in August (and -1.1% in July, after a -0.3% in June) it's apparent that the demand for long bonds is not coming from domestic savers. As we've discussed before, overseas investors have helped keep our interest rates down: 45% of all outstanding Treasuries are foreign owned, as are 83% of purchases of corporate and agency bonds. In fact, a recent study at the University of Virginia (Warnock & Warnock) suggests that absent this demand rates could be 1% to 1½% higher, creating an environment that would be much less supportive of housing asset value appreciation, and by extension, greatly curtailing domestic consumption. Absent the US consumer using their home as a piggy bank for purchases and sending dollars overseas to be re-circulated to buy our government's debt, we fear there is little to prevent a rise in our domestic interest rates to address our gaping current account deficit.

Although we feel that this current slowing in GDP could foster one last leg (albeit it a short one) down in interest rates, our sense is that rising interest rates are in our future, thereby focusing our attention on the shorter end of the yield curve, as well as in markets for floating rate, and inflation-indexed, debt, both domestically and overseas.

WEALTH MANAGEMENT UPDATE

TRACY W. ROGERS, *PORTFOLIO MANAGER*

In our most recent newsletter we discussed the need for estate planning and some of the challenges that occur at a person's demise. As mentioned, we will continue to take a high level glance at topics in the estate planning arena in an attempt to provide a background as to the importance of proactively addressing the family issues on an ongoing basis. These articles will be designed to inform, educate and hopefully facilitate changes, if necessary, in our clients' estate planning work. Two areas that we think are timely are touched on below.

Charitable Giving

One item of interest has been some recently passed legislation with regards to charitable contributions, as a result of Hurricane Katrina, between now and year end. The Hurricane Katrina relief bill, unanimously passed by the House and Senate on September 21, and signed into law by the President on September 23rd, has made changes to tax law designed to encourage certain outright gifts of cash made during the period August 28, 2005 – December 31, 2005.

Highlights of this new legislation include:

- The contribution limit for certain outright gifts of cash has increased from 50 percent of adjusted gross income to 100 percent of adjusted gross income.
- These same outright gifts of cash also are exempt from the three-percent reduction in itemized deductions for individuals with an adjusted gross income over \$145,950.
- Cash gifts to a private foundation, supporting organization, or donor advised fund do not qualify for the higher limit or the three-percent rule exemption.

These changes may present some donors with an attractive opportunity to fund outright gifts with assets withdrawn from an IRA or other qualified retirement plan. Under existing law, the maximum amount of cash contributions that is deductible in any one year is 50 percent of

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adjusted gross income. That limit is being increased to 100 percent of adjusted gross income in the case of certain cash gifts made during the stipulated period.

Document Reviews & Updates

Once a legal document is completed and signed, it is often put into a safe deposit box or file and only comes out when a conflict arises or a death occurs. Most legal documents (wills, trusts, life insurance beneficiaries, asset ownership, employee benefits recipients, buy/sell agreements, etc.) may need to be updated when a change or a life events occurs, either planned or unplanned. The following list sets forth some events that may require the updating of a legal document or an overall estate plan.

- Potential Life Events

* Marriage	* Divorce	* Death of spouse
* Change in estate size	* Move to another state	* Property acquisition or sale
* Death of trustee	* Death of guardian	* Death of executor
* Change in insurability for life insurance	* Changes in estate laws (tax/trust/probate)	* Change in business interest
* Retirement	* Birth or adoption	* Change in health or a serious illness
* Change in beneficiary attitudes	* Assuming financial responsibility for a child	* Assuming financial responsibility for a parent

As always, we and our colleagues in the legal community are willing to assist you in addressing any of these issues as they may arise. Feel free to contact us should you have any questions or concerns.

IMCG NEWS

FRED WILLIAMS – A Board member of The Dream Factory’s Portland chapter (www.dreamfactoryofmaine.org), he was recently appointed to a second term on the National organization’s Executive Committee (www.dreamfactoryinc.com). Additionally, while attending their national convention in New York last week, he was given the *President’s Award* for his work with this group that grants dreams for critically and chronically ill children.

STEPHANIE KELLEY, IMCG CLIENT ANALYST – A member of Portland’s Kiwanis chapter (www.portlandkiwanis.org), she was recently appointed to their Board of Directors, serving in the capacity of Assistant Secretary for the coming year.

RENOVATIONS AND EXPANSION UPDATE – Our building’s lobby is in the final painting stages, while our office expansion has completed the construction process. We are now awaiting the delivery of the additional furniture and administrative work spaces, all of which should arrive and be installed during the last half of October.

CALENDAR – Be on the watch for IMCG events this fall as we’re working on a reception at Victoria Mansion, as well as a holiday open house to celebrate the renovations’ completion.

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