



VIEWPOINTS

4TH QUARTER 2005

ADVISORY NEWSLETTER

MARKET COMMENTARY

FREDRIC W. WILLIAMS

Less Great Expectations...

As tends to be the norm when we conclude one year and start another, the practice of prognostication tends to float to the forefront as we attempt to decipher the financial tea leaves for the New Year. Our practice has never been so bold as to infer any specific contact with a conduit to the future, but instead to rely on data and history to better understand trends that we will want to take advantage of within the global capital markets. Our thoughts this quarter center on three topics, two of which we'll cover in this issue, saving the most expansive discussion regarding pensions and savings for next quarter. Although distinctly different, we see the dollar, housing and pensions as being closely related as we move forward through the next decade, given that each will have an impact on expectations and investor returns.

The dollar, when viewed as a medium of exchange, is like any other commodity given that its value is determined by supply and demand, along with a healthy dose of confidence about its future abundance and condition. Whether it be beads, pelts, gold coins, paper currency or shares of stock, their value will be a function of the quantity currently available, as well as a view towards their projected future returns from income (interest, dividends, etc.) or increases in relative trade value (more, or less, beads per pelt, for example). As a reserve currency, the dollar had become ubiquitous during our years of budget surpluses and GDP growth. Now, however, we face both significant current account deficits, as well as investment options other than gold (euro, yen and renminbi) that foreign central banks can consider for what they used to allocate solely to dollar reserves. As mentioned in previous columns, this recycling of dollars back in to our domestic bond market has supported our lower interest rate environment by replacing the domestic savings that we presently lack in the U.S.

Therefore, it can be argued, the dollar is trading more on confidence than fundamentals, and should we begin, for a variety of reasons from housing weakness to rising interest rates, to experience a downturn in the economy, we could see foreign reserves migrating to other options, pushing the dollar lower. Additionally, since we've relied on the kindness of strangers (overseas demand) to send our dollars back to us via the purchase of our debt, thereby keeping interest rates lower than they might have been otherwise, we could see issues should they decide to spend our dollars to finance their own infrastructure development, rather than purchase our bonds. Regardless as to the catalyst, it would appear

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that the risk to the dollar going forward is on the downside, at least until such time as the global imbalances in dollar denominated reserves are realigned.

As will be discussed in more detail later in this commentary, the rising interest rates which may be required to attract foreign capital (through the purchase of our bonds) and support the value of the dollar could have a negative impact on the domestic housing market. This dynamic is above and beyond the fundamental analysis that would suggest, much like we did during the NASDAQ's climb of the late 1990's, that it would be unlikely to expect housing values to increase, uninterrupted, at the same rate they have over the last ten years. The housing market has become viewed, much like one's 401(k) was during the heady days of the dot com boom, as a linear savings projection for both retirement and current savings. This has created a complacency that has cause consumption to skyrocket and savings to plummet – U.S. consumers are on track to have spent \$39 billion more than they earned in 2005 (according to government data releases during the holiday shopping season)...the last time that consumer spending outstripped earnings was in 1933. As Ben Stein points out in *Forbes*, this cash is not coming from savings:

"Savings rates have never been lower. In 1999, the national savings rate dipped below 3 percent for the first time since 1959, according to the U.S. Commerce Department. It has been declining further since then, and in 2004 it was at a mere 1 percent. The low savings rate, coupled with large deficit financing by Asian banks, is dangerous for the U.S. But it's more dangerous for individuals."

The source, then, of this consumer largesse has been the pervasive use home equity loans, coupled with a mentality that ones home can be viewed as an ATM with an ever increasing balance to draw off of. Unfortunately this fails to account for a few realities, like rising interest rates, the ultimate payback of the debt, and perhaps the biggest concern being that should housing growth and values return to reality, there could be a potential impact on the employment necessary to make the monthly mortgage payments themselves. As Alan Abelson points out in the December 12th edition of *Barron's*:

"The great housing bubble is popping and the consequences are shaping up as dire, indeed. Not only is the value of the happy homeowner's house in jeopardy, but also obviously its ability to finance his free-wheeling spending; the end of the housing boom might even pose a threat to his job. On this score, the Anderson Forecast, conducted under the auspices of UCLA and released last week, bleakly predicts that the decline in housing will run a good several years, in the process reaping a grim toll on jobs -- possibly 500,000 in construction and another 300,000 in the financial sector."

Much like the capital markets, the housing market twenty years out will provide ample positive returns; unfortunately, just like the tech market of the late '90's, the excessive increases in value recently witnessed will have to be corrected before a more normal rate of appreciation can resume.

With these general themes as part of our macro backdrop going forward, we'll continue to adhere to our moderate expectations that emphasize global diversification along with cash flow oriented asset allocations – our goal being to, over time, generate real rates of return and mitigate volatility.

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Much Ado About Not Much...

Thanks largely to the 4th quarter rally off the October lows, the domestic equity markets ended 2005 almost exactly where they started the year, further extending the trading band which started in January 2004 and which has seen, for example, the DJIA rise a mere 2.9% in 2 years, exclusive of dividends. Once again energy prices, interest rates, geopolitical events and the domestic economy were factors in keeping the markets in check. As noted by Michael Santoli in the January 2nd 2006 issue of Barron's:

"Stocks traded on 252 days last year. Three quarters of a trillion shares changed hands. And (sorry for this part) untold gallons of ink were spilled describing it all. Yet, in the end, the Dow Industrials did as close to nothing during 2005 as they have in nearly 80 years.

The Dow's finish 0.61% below the 2004 closing level qualifies as its smallest calendar-year percentage change since it gained 0.34% in 1926. And 2005 stands as one of four in the DJIA's 110-year history (along with the primordial years 1902, 1911 and 1926) in which it moved less than 1%.

For trivia buffs, it was also the first year when the Dow failed to rise in a year ending in 5, and indeed the first time a "5" year saw anything less than a 10% rise."

Other than the Dow's treading water, the S&P 500 finished the year up 3%, due largely to its greater exposure to energy companies, while the NASDAQ moved ahead by 1.37%. Like last year, and despite October's profit taking, the Dow Jones Utility Average surged another 20.95% in 2005 as nervous investors sought out the relative security of dividend cash flow. Ongoing concerns about the economy and corporate profits growth, despite encouraging signs late in the year, continued to constrain enthusiasm in the capital markets. Relatively low interest and unemployment rates can't seem to move investors off the sidelines and strong corporate profits and cash coffers haven't been catalyst enough to initiate capital expenditures or expansion.

As we've pointed out since the start of 2005, the most productive equity markets were overseas, given their lower valuations and improving fundamentals. Many foreign bourses saw outsized gains, with Tokyo's Nikkei-225 rising 40.2%, it's largest gain since 1986, London's FTSE 100 up 16.7%, the Paris CAC-40 increasing 23.4% and the Frankfurt Xtera-Dax gaining 27.1%. The moon shot of the year, albeit not an entirely comfortable investment environment of late, was the Russian Traded Index which jumped 61.8%, and slightly nosed out more investor friendly emerging markets like Istanbul's IMKB-100 (up 59% for the year), along with Seoul's Kospi and Karachi's 100 (both +54%), as well as natural resource rich Oslo's All-Share index which climbed 52%.

Although we will continue to be attracted to dividend cash flow in our domestic equity allocations as we move in to 2006, we continue to be drawn to the aforementioned lower valuations and higher dividend rates that can be found offshore, particularly in a year when we expect to see relative weakness in the dollar. Gradual social economic restructuring in Europe will somewhat constrain growth, but the approximate 25% more in dividends (DJIA

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vs. DJ Stoxx) seems like ample cash flow while waiting for the results from Euro-land. We also sense a shift in Asia, with their export-centric model morphing in to a regional and global force powered by the self-sustaining consumption of 2.6 billion people.

With a slowing domestic housing market and the likely prospect of higher interest rates in the New Year, we'll continue to eschew overly concentrated U.S.-centric portfolios in favor of more globally diversified portfolios that can take advantage of valuation opportunities as they arise.

BOND MARKET OVERVIEW

INVESTMENT POLICY COMMITTEE

Inverted Yield Curve...

Despite the nostalgia of Alan Greenspan's "Swan Song" and what was The Federal Open Market Committee's (FOMC) 13th consecutive increase in the overnight bank lending rate at their December meeting, The Fed Chairman continued to be confounded by the "conundrum" of the domestic bond market during the 4th quarter of 2005. In fact, during the last week of the year a contributing factor in the weakness of the domestic equity markets was the inversion of the Treasury market with the two year note yield closing the year at nearly 4.4%, while the ten year ended up a tad lower at 4.39%. This highly unusual statistic, which inverted last in 2000, is a fairly accurate predictor of economic weakness, having presaged more than two thirds of our last recessions, and still sparks considerable debate amongst academicians and investors. Regardless as to the direction and condition of the economy, there are two areas which will be adversely impacted in the New Year if this condition continues: lending and housing.

Traditional lenders, like banks, have "borrowed short and lent long" thereby benefiting from the positive slope of the yield curve – in a general sense, that carry trade has become much less profitable as the Fed has pushed rates higher, thereby limiting lending activity, along with the accompanying revenues and profits. On the housing (bubble) front, given that short term rate increases adversely impact the elixir of our recent boom (cheap money), we can expect that the resulting annual upward adjustments in monthly payments will curtail the consumer's desire (and ability) to "super size" through another purchase. Since that vast majority or recently written mortgages have been ARM's tied to changes in shorter term interest rates, it's quite plausible that this set of circumstances will be a wet blanket on the upward spiral in prices.

With 3rd quarter GDP running at 4.1%, the November unemployment rate holding at 5%, core inflation less than 2% and a recent bump up in consumer confidence coming in to the holiday season, it's hard to see this concern about the economy in the near term data. We still expect the new chairman of the Federal Reserve, Ben Bernake, to take the reins in February and oversee at least one more increase in short term interest rates, given the need to assuage market concerns that he be a vigilant inflation fighter like his predecessor.

Our interest rate picture going in to 2006 will continue to err on the side of conservatism, with our view that short rates will be pushed higher, if not to offset inflation then to support the dollar in light of our massive current account deficit. Although this could, given the

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impact that lending curtailment and a decline in housing could have on the overall economy, result in near term economic weakness, we still want to position ourselves for rising domestic interest rates and a declining dollar when it comes to our fixed income exposure.

WEALTH MANAGEMENT UPDATE

TRACY W. ROGERS, *PORTFOLIO MANAGER*

As is our practice during the last quarter of the year, we want to overview the various tax advantaged retirement and savings plans that should be considered as part of your comprehensive planning process. In addition, we also like to make a point to touch on any new topics of interest that might be relevant to your individual situation or company savings plan options.

As of January 1st 2006, companies are able to offer the new Roth 401(k) plan in addition to the traditional 401(k) plan. In the Roth 401(k) option, contributions are taxed (after-tax dollars) going into the plan. The tradeoff for taking the tax hit sooner rather than later is that you will be able to have qualified distributions (withdrawals) from your contributions and any earnings would be tax-free. The Roth 401(k) contributions are simply another option for employees. They are just like traditional salary deferrals for the purpose of calculating a company match and compliance testing.

The Roth 401(k) is the total opposite of the tax treatment your traditional 401(k) contributions and withdrawals receive. You invest pretax dollars in a traditional 401(k) and therefore have more investment dollars working for you from the beginning, but you will pay ordinary income tax on your withdrawals, and maybe a 10 percent penalty if you are under the age of 59½. There is no income limitation governing who can contribute to either type of account, and the same contribution limits that apply to a traditional 401(k) will also apply to a Roth 401(k). In 2006, you can contribute \$15,000, plus an additional \$5,000 if you are age 50 or older. That limit applies to your total contributions to both accounts — that is, you won't be able to contribute \$15,000 to a Roth 401(k) and another \$15,000 to a traditional 401(k).

Other limits of interest are as follows:

Plan Type	2005	2006	2007	2008
IRA	\$4,000	\$4,000	\$4,000	\$5,000
- Over 50 Catch Up	\$500	\$1000	\$1,000	\$1,000
Roth IRA	\$4,000	\$4,000	\$4,000	\$5,000
401(k) Salary Deferral	\$13,000	\$14,000	\$15,000	Indexed for Inflation
- Over 50 Catch Up	\$3,000	\$4,000	\$5,000	Indexed for Inflation
SIMPLE Salary Deferral	\$10,000	\$10,000	*	*Indexed for Inflation
- Over 50 Catch Up	\$2,000	\$2,500	*	*Indexed for Inflation
403(b)/457 Salary Deferral	\$14,000	\$15,000	*	*Indexed for Inflation
- Over 50 Catch Up	\$4,000	\$5,000	*	*Indexed for Inflation
Coverdell IRA	\$2,000	\$2,000	\$2,000	\$2,000

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As always, we and our colleagues in the legal and accounting 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

FRANCIS J. "TERRY" DAVIES – We're very pleased to announce Terry joining the firm as a Vice President – Portfolio Manager. Most recently with Westport Capital Markets, where he was a Managing Director, we're looking forward to his years of experience on Wall Street as he becomes an integral part of IMCG's Investment Policy Committee. Starting with Laidlaw Asset Management in New York in 1983, Terry has honed his skills as both a trader and portfolio manager for clients throughout the country. Terry lives in Falmouth Foreside with his wife Margo and their sons Jack and Sam. Additionally, Terry sits on the Board of the Preble Street Resource Center, serving on its Finance Committee.

ALLISON RAMIREZ - The newest member of IMCG's client management team, Allison joins the firm as a Client Service Associate. Prior to coming to Portland to be with our firm, she worked for the National Securities Corporation in Seattle Washington. In her position with us, she will be responsible for client consultation scheduling as well as internal systems analysis and software integration.

FRED WILLIAMS – He was recently appointed to second terms on the Boards of 75 State Street (www.75state.org) and Portland's Community Television Network (www.ctn4maine.org); he is currently serving on the Finance Committee as Treasurer with both organizations.

RENOVATIONS AND EXPANSION UPDATE – Both the building's renovations and our offices' expansion are now complete; we invite you to come and see our new space!

REMEMBRANCE – It is with a heavy heart that we announce the passing of Dugal Thomas, our Director of Marketing, in early November. During his, albeit too brief, tenure here he shared immense amounts of wisdom with us from his 35 years in the business. How he approached life, and faced his challenges, will be a tremendous inspiration to all of us in to the future.

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