



VIEWPOINTS

1ST QUARTER 2006

ADVISORY NEWSLETTER

MARKET COMMENTARY

FREDRIC W. WILLIAMS

More Less Great Expectations...

It has become evident over the last few years that pension obligations now pose a significant threat to the budgets of private companies as well as the state and federal governments that will be the banks of last resort. The fragile health of these plans has been playing out in the media as a result of a variety of labor negotiations addressing the retirement benefits expected by auto workers, pilots and public transportation workers, amongst others. These retirement plans are referred to technically as defined benefit plans and had their genesis in the industrial and manufacturing economy of the first part of the 20th century. Coupled with Social Security in the 1930's, this combination of private and public funding was designed to create retirement security for workers in their "golden" years".

Unlike the 401(k) plans that arose in the 1970's, known as defined contribution plans, pension plans were funded exclusively by employer contributions. This created a promise, or obligation, to pay a future benefit calculated on tenure and salary variables, and based on employer assumptions of investment rates of return and life expectancies. As a result of increased life expectancies, and the baby boom generation moving into retirement, the financial realities of these past obligations are creating current monetary demands that could have significant impacts on our expectations for economic growth.

For example, most of the people on the payroll at General Motors are retired. GM sends pension checks to nearly half a million former workers. In addition, they provide a generous health care plan to 1.1 million people — retirees, workers and their dependents — that costs the company \$6 billion a year. Along with the weakening dollar and softening housing market, the contributions these plans will require going forward could be a significant drag on the pace of economic growth.

Similar to the simple metric facing Social Security whereby more retirees than anticipated are drawing benefits from fewer current workers making contributions to the system, pension plans are becoming the gorilla in the closet that will require our attention. A few observations from John Mauldin's November 4th 2005 issue of *Thoughts From the Frontline*:

"In the mid-80's, there were 112,000 defined benefit plans. Today there are just over 31,000. As more and more executives realize that making commitments for 40 to 50 years into the future is fiscal

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insanity in a world of accelerating change, we will see the number of defined benefit pension plans drop even more.

But it is not just the fiscal insanity that should lead executives to abandon defined benefit plans. Let's assume you have an employee that is 50 years old and has been working for you for 25 years. It is highly likely that he is going to live to at least 90 if not 100 years old. He is planning on retiring in 10 to 15 years with that nice retirement you promised, indexed to inflation of course.

But the reality is that few companies will be able to fund that plan 30 years from now, let alone 40 or 50. The world is going to be so completely different from what it is today that no 30 year plan will survive intact. We are no longer living in the 1950s or 60s when such long-term planning made sense. It borders on the immoral to allow a worker to retire, thinking they are set for life, when those promises are going to go up in smoke. Or they will be handed over to the PBGC where taxpayers will get the privilege of making those payments."

The magnitude of the dollars involved, as well as the ultimate funding resolution options, are what would seem to limit future growth prospects. For public plans the contributions will have to come from tax receipts (i.e. we as taxpayers), while the private sector will see an increasing portion of their operating revenues being dedicated to meeting their pension obligations. This leaves less capital for private enterprise to invest for growth, and lower net taxes for whatever services we as citizens deem important to have provided.

In late December of last year, Roger Lowenstein authored an article in the New York Times where he estimated that corporate pensions were under funded by \$450 billion and government plans by another \$300 billion. According to Barclays Global Investors they see public/government pensions alone in the red by at least \$460 billion.

"Now, most of that liability is from companies that are solvent and at the end of the day will be able to meet their pension obligations. But a significant portion will not be able to. The PBGC tells us they are \$23 billion in the red at the end of 2004. This is expected to rise to \$30 billion when the books for the third quarter are closed. A Congressional Budget Office (CBO) report last week predicted a jump in PBGC liabilities to \$87 billion over the next decade and \$142 billion in 20 years... In the last three years, almost 600 companies have reneged on pension-fund obligations, with 21 plans each totaling \$100 million or more, topped by United's pension fund failure at \$9.8 billion, the biggest since the government began guaranteeing pensions in 1974. In June, Delta Air Lines and Northwest Airlines told Congress their plans would default unless legislators extended the funding deadline. The automakers, short by \$55 billion to \$60 billion, may not be far behind." J. Mauldin 11/4/2005

Combine those capital requirements with the paucity of domestic savings and an argument can be made that our economy may have limited access to the funds necessary for future expansion and consumption. Revenues that would have otherwise supported these endeavors could end up being required as contributions to under funded pension plans, or to bolster personal savings in advance of retirement. Given the demographics of the Baby Boom generation, the absence of sufficient domestic personal savings could have a ripple effect through the economy as consumption, which still represents approximately two-thirds of our GDP, is scaled back and directed into preparing for retirement.

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As Ben Stein wrote in *Forbes* last fall:

"Nearly 28 million U.S. households - 37 percent of the total - do not own a retirement savings account of any kind. Among the households who owned a retirement savings account of any kind as of 2001, according to a 2004 report by the Congressional Research Service (CRS), the average value of all such accounts was \$95,943. That number was distorted by the relatively few large accounts, and the median value of all accounts was just \$27,000. The median value of the retirement accounts held by households headed by a worker between the ages of 55 and 64 was \$55,000 in 2001, and just 11 percent of all Americans have retirement savings of \$250,000 or more. You can jabber to people about saving money until your jaw falls off; they're not going to put an extra dime in a savings account - not when property prices are going up at 10 percent per year and the Fed is still giving away money. Eventually, however, the things that must happen sooner or later do happen. Of course, that's when people wish they had saved money. That's when they'll really need it. That's when the whining really begins."

As we outlined in the past, 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 still being to, over time, generate real rates of return and mitigate volatility.

EQUITY MARKET OVERVIEW

INVESTMENT POLICY COMMITTEE

And They're Off!...

In contrast to last year's lackluster domestic equities performance, the first quarter of 2006 saw U.S. markets turn in one of their best showings in years. Despite rising interest rates and oil prices near \$70 a barrel, the Dow Jones Industrial Average gained 391.82 points, or 3.66%, to 11109.32 in the quarter, its biggest first-quarter gain since 2002. The Standard & Poor's 500-stock index, was up 3.8% to start the year, the strongest first-quarter advance since 1999, and the Nasdaq Composite Index climbed 6.1%, its best start since 2000, while the Russell 2000, a gauge of small companies, is up 13.7% year-to-date - its best opening-quarter salvo since 1991.

While higher rates unnerved investors periodically throughout the quarter, since they tend to slow economic growth, making it tougher for companies to borrow and consumers to spend, stocks managed to churn upward amid speculation that the Federal Reserve would soon end its campaign to boost rates. A bit of air was let out of that balloon when Chairman Bernanke, presiding over his first F.O.M.C. meeting bumped rates ahead by another 25 basis points and indicated that the Fed was not yet done fighting perceived inflationary pressures.

Although not as dramatic as last year, overseas markets continued to outperform their domestic brethren, with Tokyo's Nikkei-225 rising 5.89%, London's FTSE 100 up 6.15%, the Paris CAC-40 increasing 10.72% and the Frankfurt Xtera-Dax gaining 10.39%. As was the case last year, the emerging markets contained the quarter's performance stars with the Russian Traded indexed jumping 26.11%, India's Bombay Sensex up 20.03%, and Argentina's Merval ahead by 16.67%.

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Full year 2005 GDP came in at 3.5%, despite the 4th quarter slowdown to 1.7%, and preliminary indications are that the first quarter of 2006 will be in excess of 4%, although the effects of higher interest rates and energy prices are expected to cool that number as the year progresses. With profits from the S&P 500 companies expected to decline from their above average 14% growth rates last year, to more normal 7% to 10% this year, it would appear the trend would have to be best considered as neutral given the back drop of valuation levels and interest rate trends. As a result, we will continue to focus on dividend cash flow and overseas exposure to hedge the dollar and provide acceptable relative total returns.

BOND MARKET OVERVIEW

INVESTMENT POLICY COMMITTEE

Another Quarter...And Two Quarters...

The first quarter of 2006 saw the retirement of Alan Greenspan as the Chairman of the Federal Reserve and the long awaited "ascension" of Ben Bernanke to take his place. Other than those changes, all that the bond markets got from Washington was more F.O.M.C. medicine in the form of two more quarter point increases (the 14th and 15th) in the Fed funds rate.

Last week, at the Fed's first policy meeting under Chairman Ben Bernanke, policy makers raised the target for the federal-funds rate, charged on overnight loans between banks, to 4.75% from 4.5%. After he presided over his first Fed interest-rate meeting last week, he sent out a signal that he intends to be as determined an inflation fighter as were predecessors Alan Greenspan and Paul Volcker. The post meeting statement said more rate increases might be needed to prevent inflation, which investors took to mean that the Fed would definitely push its benchmark rate to 5% at its next meeting, in May, and might send it higher in June.

With rates moving up across the yield curve, last quarter's yield curve inversion became this quarter's pancake as the 2 year note finished March at 4.82%, the 10 year at 4.85%, and the reintroduced (after a 4 year hiatus) 30 year bond closed with a 4.89% yield. In this environment a 7 basis point positive spread would not seem to warrant occupying anything other than the short to intermediate portion of the credit markets.

Although the housing market bubble appeared to leak a bit of air, the economic data continued to be reasonably positive. In addition to the aforementioned GDP data projected for the first quarter, personal income and consumer sentiment both moved modestly ahead. The Purchasing Management Association of Chicago's index of area business activity rose to 60.4 in March from 54.9 in February (readings above 50 indicate expansion) and the prices-paid index, a key inflation metric, fell to 71.1 in March from 71.6.

Our interest rate picture looking at the balance of 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. We still want to position ourselves for rising domestic interest rates and a declining dollar when it comes to our fixed income exposure.

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Starting January 1st 2006 the Roth 401(k) arrived, and this new retirement plan option may potentially represent an exceptional financial and tax planning opportunity for you to consider, as employers can now add an optional Roth feature to a 401(k) or 403(b) plan. Unlike the Roth IRA, where eligibility is limited by income, there are no restrictions on who can contribute to a Roth 401(k). Assuming their employer offers the feature, plan participants can generally make after-tax Roth contributions of up to the \$15,000 limit in 2006. (The limit is \$20,000 if the participant is age 50 or older and in a plan allowing "catch-up" contributions.) Like the Roth IRA, participants in the 401(k) version forfeit the tax benefit they receive from pretax savings, but in exchange receive permanent tax-free withdrawals during retirement. Once an account has been opened for at least five years and the owner has reached age 59 ½, all withdrawals from the Roth 401(k) account, both contributions and earnings, are completely free of income taxes. Given this tax benefit, Roth savings can also offer a valuable estate planning strategy since heirs and beneficiaries will not owe income taxes on qualified distributions.

The Roth 401(k) may help investors with another strategy: tax diversification. Most workers are putting money into a workplace retirement plan on a pretax basis and taking a tax deduction today, hoping to pay the IRS later, during retirement, when their tax rate is presumably lower. Given the changes to the tax system during the past two decades, it's not guaranteed that an investor's marginal tax rate will fall in retirement. Brackets are wider today so there's a good chance of being in the same tax bracket in retirement. Although this is the case with investors who have substantial assets of their own or who are receiving generous employer-provided benefits, pensions and executive compensation plans, it's also true for the many low- and middle-income workers paying at a 10% or 15% tax rate today.

Embedded within all pretax retirement assets is an unavoidable risk - that tax rates could move higher in retirement, rather than lower. Prudent investors diversify equity market risk with fixed income investments, real estate and other holdings, so it's similarly important to hedge tax risk (the notion of "tax diversification") by holding both pretax and post-tax savings.

If the Roth 401(k) has been made available to you and you would like to discuss the advantages or disadvantages of using it in your specific situation, please call so we can schedule a consultation. In addition, our firm manages and consults to employer sponsored 401(k) and 403(b) plans and would welcome the opportunity to discuss with you, or your employer, IMCG's disciplined approach to these important employee benefits and the fiduciary issues that accompany them.

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

Since this is my first contribution to the IMCG newsletter, let me start by saying how pleased I am to be part of such a respected investment advisory company. As their long-time clients know, IMCG offers guidance on all aspects of their financial lives. The firm coordinates an overall plan of spending, taxes and estate planning and combines that with an investment

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policy tailored to address these real life concerns. My own professional experience has been focused mainly on the selection and management of investments and I wanted to offer my clients this type of comprehensive assistance. Happily, now I can. This service is what distinguishes a registered investment advisory firm – or RIA – from the many other sources of investment advice available in the market place.

A ‘registered’ investment advisory, like IMCG, is ‘registered’ with the Securities and Exchange Commission under the Investment Company Act of 1940. Being subject to this rule creates a very clear distinction between an RIA and anyone else – whether they charge a management fee or call themselves “financial advisers”, “investments consultants” or “wealth managers.” That distinction is “Fiduciary Responsibility,” a term that has a very simple and legally binding meaning. Unless one is an RIA, they are not held to this rigorous standard.

A fiduciary has a legal obligation to “act in good faith in the *best interests of the client*”. This means when we select an investment, we are responsible to make sure that not only is it appropriate for our clients, but that it is *the best investment available*. This means we must disclose everything that affects our relationship with our clients. Our disclosure comes in the form ADV – a document that all of our clients receive before they open an account and one that we must, by law, update each and every year. This filing reveals how we do our business, how we are paid and by whom. If an RIA chooses to compensate for referrals or gets paid by a particular brokerage for keeping client assets there – it must be disclosed.

This common sense rule applies only to RIAs. In contrast, a broker charging a fee can still sell the customer stocks that the firm needs moved out of its inventory without revealing the conflict of interest. Like wise, a financial planner not registered as an RIA is free to push a mutual fund that will financially benefit the firm. Of course, not every salesperson in that position would choose their own paycheck over the interests of their client; the point is that legally they can. Under the law, the client has to find any ulterior motivation on their own. Not everyone thinks this discrepancy is fair to the public. According to Arthur Levitt, Jr., a past commissioner of the SEC, “Brokers and advisers should be bound by similar fiduciary standards.”

There is one clue that an advisor is not subject to the fiduciary standard. A non-RIA must print a disclosure clause somewhere on its new account documents. It states in part, “Your account is a brokerage account and NOT an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and obligations to you. We are paid both by you and, sometimes, by people who compensate us based on what you buy.”

It is clear why that would be printed in very small letters. In stark contrast, IMCG does not accept commissions or incentives to sell investment vehicles. We are fiduciaries that provide conflict free portfolio management and financial planning advice that serves only the best interests of our clientele.

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IMCG NEWS

PORTLAND OFFICE EXPANSION – We're very pleased to announce the completion of our renovations and expansion. We look forward to your visit so we can show you our space as we continue to add to our team of professionals.

STEPHANIE KELLEY – We're sad, but proud, to announce that Stephanie will be relocating to Washington D.C. to begin graduate school. Having joined us from Congressman Allen's office with a degree from Notre Dame in political science, she will be pursuing studies in public policy, urban planning and economic development. Stephanie has been a great asset to our team and we wish her the best in her new endeavors!

EVENTS – Mark you calendars for a couple of IMCG sponsored events this quarter:

- **USM 4th Annual Ethics Symposium** – May 5th 8:30 to 11:00 AM, 7th Floor of the Glickman Library; for registration information please access the School of Business website at www.usm.maine.edu/sb/ or call Carla Harmon at 780-4022.

- **13th Annual “Child’s Play” Charity Golf Tournament to benefit The Dream Factory of Maine** – June 2nd 11:30 AM at Sable Oaks Golf Club, followed by a lobster bake. Contact our office for more information or go to www.dreamfactoryofmaine.org and view Upcoming Events.

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