



VIEWPOINTS

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ADVISORY NEWSLETTER

MARKET COMMENTARY

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Gimme Shelter...

The 1969 film "*Gimme Shelter*" chronicled the Rolling Stones tour that ended in tragedy at Altamont Speedway and signaled the demise of the 60's counterculture era. The title of the movie and its ending suggest parallels to the state of today's domestic housing market and its potential for a troubled ending. Real estate, particularly housing, has had a well publicized run that has taken valuations and affordability to levels that are eerily reminiscent of the tech stock bubble in the late 1990's. The ancillary economic benefit on the way up has been to provide the fuel for a consumer spending boom that has taken real estate debt to record highs and domestic savings rates to record lows. Our concern is that now, as the music stops and air comes out of the bubble, the decline in housing values will impact consumer's ability to "spend" our GDP forward.

To put in perspective the magnitude of this upswing there is a plethora of data to sift through:

"Housing began its big move earlier than capital expenditure -- in 1990, to be more precise -- when it accounted for only 3.5% of GDP. And as a proportion of GDP it has gone straight up ever since, ballooning to an all-time peak of 6.2% in the first quarter of '06. The point, obviously, is that housing, only now starting to slip, could follow the pattern sketched out by capital spending. Since it went on longer and its impact is comparatively greater, housing could become a more formidable drag on the economy. And a drag that isn't apt to disappear overnight, or even in a year or two" A. Abelson, Barron's 7/1/06

"Not the least of reasons for taking a wary stance on housing is that there seems to be so much darn room on the downside. Boom doesn't really begin to describe the extraordinary upswing now ending. As a recent report by HSBC on the industry observes, increases of 100%-150% in sales, starts, building permits and home-builder optimism from the bottom of a housing cycle to its peak are pretty much the norm, and the advances have tended to last four or five years. This one, in striking contrast, has gone on for some 15 years, with gains in the aforementioned indicators ranging from 130% to 300%." A. Abelson, Barron's 6/26/06

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In addition to quantifying the outsized presence and impact housing has had in our economy, it's instructive to be aware of historical financial relationships that are based on elementary supply and demand dynamics:

"However, history reminds us that over the long-run housing price gains should roughly match income gains. With current +13% annual housing price gains exceeding the +4% growth in personal disposable income by a record margin, today's environment appears unsustainable. The current +9% gap is unprecedented in looking back over the past 30 years. This trend should reverse course. While Fed tightening has so far done little to change lending standards, delinquency rates are picking up and foreclosure rates are rising. In addition, banking regulators are beginning to crack down on risky loans and lending practices. These are clear signals that lending standards are set to tighten." M. Kiesel, PIMCO – 6/06

The canary in the mine at this point centers on inventory – instead of a bidding war between buyers, we may move toward a similar frenzy with sellers:

"Housing inventories are becoming a problem. Presently there are almost 4 million homes available for sale nationwide, including 3.383 million existing and 565,000 new homes. Current inventories are at record levels, having risen 27% and 37% year-over-year for new and existing homes, respectively. Given declining affordability and rising inventories, we expect to see homes for sale remain on the market longer and asking prices come down. The housing market should quickly transition from a sellers' market to a buyers' market." M. Kiesel, PIMCO – 6/06

"Not only are sales slowing, but, meanwhile, inventories of unsold houses are going through the roof. Builders, as always, have a tendency to keep building so long as some lender out there is silly enough to give them money. Nor is it only new homes that aren't selling like hot cakes these days: according to the National Association of Realtors, existing-home inventories were up by more than 30% over a year ago, the biggest such rise since the NAR started to keep tabs back in 1983...Another set of numbers, which comprise an index compiled by the National Association of Home Builders (affectionately known to the housing crowd as the NAHB), measures the buoyancy of the housing market. The latest reading was 42, down from 68 only eight months earlier; that's the worst eight-month slump ever." A. Abelson – Barron's 6/26/06

Rising interest rates have contributed significantly to the initial stages of a slowing housing market, and there's a direct correlation to the tone and tenor of consumer activity when they see the value of their largest piggy bank unable to keep up with the cash out refinancings they've become accustomed to.

"The last comparable bout of Fed tightening, in 1994-95, resulted in a housing downturn that led to a slide in consumer spending, writes Sharon L. Stark, chief strategist of Stifel Nicolaus. And rate hikes led to falling house prices and retail sales in Britain and Australia in 2004, add analysts at BCA Research...This time, it could

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be worse than in 1994-95. Payment shock is beginning to hit all those crazy adjustable-rate mortgages...real-estate now comprises a much bigger portion of household assets while housing equity is lower, thanks to the magic of leverage."

R. Forsyth, Barron's – 7/1/06

Since, as previously noted, the consumer's wallet is already under siege from rising energy prices, the impact of rising mortgage payments could be a substantial drain on disposable income:

"More specifically, Mr. G stands guilty of committing a capital crime several years back by regaling the peasants, who considered his every word a divine utterance, on the joys of adjustable-rate mortgages (as opposed to the old stodgy fixed-rate variety).

As it happened, he couldn't have picked a worse moment to make what Stephanie Pomboy of MacroMavens nicely dubs his "call to ARMs." Yields were their lowest in 40 years, but poised to begin a remorseless climb up the slippery slope.

The masses who rushed to follow the master's advice are only now starting to feel the pain of their folly. Stephanie reckons that some \$1 trillion of adjustable-rate mortgages are due to be reset this year and another \$1.7 trillion next. In the event, legions of homeowners will have to cough up 25% more every month and, for some, the bite will be as much as 60% greater.

Our melancholy prediction is that, what with killer prices at the pump and inflation extending its merry spiral, come winter a goodly number of said homeowners will find themselves too strapped to pay their fearsome oil or natural-gas bills. Having long since picked the neighborhood clean of sticks and twigs to kindle in their fireplaces, they'll have no recourse but to strive to stave off the chilblains by burning effigies of the beloved Mr. Greenspan." A. Abelson – Barron's 6/26/06

As we've discussed in the past, these dynamics continue to support our cautious view of the future - 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

What Goes Up...

After a robust start to the New Year during the initial quarter, the 2nd quarter of 2006 provided headwinds and turbulence for the equity markets both domestically and overseas. After flat-lining it for most of 2005, the indices climbed through the winter to their eventual near record peak in May before backing of their highs amid concern about interest rates, inflation and the future direction of the economy. Up to that point the markets were betting the economy would keep chugging along and that corporate profits would continue to increase at a double-digit pace, despite indications that inflation was on the rise. But on May 11, a day after the Fed boosted the target for the federal-funds rate to 5%, it all came crashing down. The Dow industrials shed 142 points, or 1.2%, that day. The Russell 2000 lost 2.4% and proceeded to shed as much as 14% in a matter of weeks. Unease with the new Fed chief

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also contributed to stock-market volatility. Comments from Mr. Bernanke caused stocks to surge on some days, and plummet on others, as investors grappled with his opinion about inflation and how high rates would need to go.

Amongst the domestic markets only the Dow finished the quarter higher, as the industrials added 0.4% to pass the mid-year mark up 4% for the first 6 months of 2006. The S&P 500 slipped 1.9% during the quarter, leaving it up 1.8% for the year, while the NASDAQ more than retraced its earlier gains, dropping 7.2% during the quarter and is now down 1.5% year to date. Although still up for the year, the Russell 2000, a proxy for the small cap universe that's been on a tear, hit an air pocket and lost about 3% during the period, after its aforementioned plummet during May.

Foreign markets teetered as well as investors fled more risky bets in emerging market equities. Benchmark indexes from Norway to India posted dizzy declines, hurt by the threat of a slowing U.S. economy as well as by tighter monetary policy by central banks in Europe and Japan. Despite those declines, the developing markets continued to lead their developed brethren, with China, Argentina, Russia and South Africa ahead by 10% to 33% at the mid year mark. Other than Japan's correction after its multi year advance, the developed markets gave back some of their first quarter gains, but continued to provide positive returns, as well as a hedge against a declining dollar. Tokyo's Nikkei-225 finished the quarter off 3.76% for the year, while London's FTSE 100 eased to a 3.82% gain for the year, the Paris CAC-40 closed the second quarter up 5.32%, and the Frankfurt Xtera-Dax was ahead 5.09% year to date.

European stocks took a breather from the previous year's strong growth after the European Central Bank started raising interest rates. The ECB last raised interest rates a quarter of a percentage point early last month, with its key lending rate now 2.75%. Asian markets, which extended last year's gains in the first quarter, mostly fell. In India, the latest emerging-market darling, the Bombay Stock Exchange's 30-stock Sensitive Index, or Sensex, declined nearly 6%. South Korea's Kospi index fell 4.7%, and Thailand's SET Index fell 7.5%. In U.S. dollar terms, some Latin America indexes fell sharply. Colombia was hit the hardest, with a 38.6% decline in its Bogota IGBC index, while Argentina's Merval Index shed 5.1%. In Brazil, despite its rapidly expanding, commodities-rich economy, the Sao Paulo Bovespa Index sank 3.2%. Mexico's IPC All-Share index fell 4.1%.

Much like the markets, 2006 started with a bang as first quarter GDP was revised upward to a 5.6% annual rate, while expectations for the second quarter are much more sedate given the expected lagging impact of rising interest rates and continue high energy prices. These factors will continue to require cautious monitoring as we move through the year, and will support our disciplined approach to dividend cash flow and ongoing non-dollar denominated asset exposure.

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Darth Bernanke...

With the honeymoon officially over, the first quarter plaudits for the new chairman of the Fed have become more strained as continuing increases in rates, coupled with an ongoing struggle to decipher Bernanke-speak, have begun to extract a measure of discomfort from the capital markets. The end of the quarter saw the Federal Open Market Committee raise its target for the overnight federal funds rate by a quarter percentage point for the 17th straight time, to 5.25%. This left the yield curve in a distinctly saucer shaped condition, with 2 year notes closing the quarter at 5.15%, 10 year at 5.14%, and the 30 year bond ticking up slightly at 5.19%.

All eyes will now focus on developments between now and the next F.O.M.C. meeting on August 8th, to determine how the admittedly "data-dependent" Fed intends to proceed. The statement from the June meeting, and the spark that drove the markets higher late last week, was the observation that economic growth was in fact moderating under the barrage of two years of rate increases.

Consumer spending in the U.S. rose in May by the least in three months, and a measure of inflation watched by the Federal Reserve was unchanged. Spending increased 0.4 percent after a gain of 0.7 percent in April, the Commerce Department reported, while the personal consumption expenditure deflator, excluding food and energy, rose 2.1 percent from a year ago, the same pace as the previous month. The report also showed incomes rose 0.4 percent, more than expected, after a 0.7 percent increase that was larger than the government reported last month. The May rise reflected a jump in proprietors' income, while wages were unchanged. Despite that, the U.S. savings rate fell to minus 1.7 percent, from minus 1.6 percent in April. Disposable income, or the money left over after taxes, increased 0.3 percent following a 0.6 percent rise the previous month and were up 4.7 percent in the last 12 months.

The price gauge tied to spending patterns and excluding food and energy costs, the personal consumption expenditure core deflator, rose 0.2 percent in May for a second month. Taking into account changes in prices, spending rose 0.1 percent last month after a 0.2 percent rise in April. Inflation-adjusted spending on durable goods, such as autos, furniture, and other long-lasting items, fell 0.6 percent after rising 0.3 percent. Purchases of non-durable goods dropped 0.1 percent after rising 0.4 percent. Spending on services, which account for almost 60 percent of all outlays, increased 0.3 percent after rising 0.1 percent.

As noted in the first portion of this commentary, the Fed is walking a fine line given that rising rates will have an adverse impact on the mountain of adjustable rate mortgages that have flooded the housing market in the last several years. Given the significance of consumer activity in our economy, increased mortgage payments could sap the discretionary expenditures that have been pushing GDP along – and that could lead to recessionary risks later this year and in to early 2007. Our interest rate picture is still looking for increased upside over the near term, but our concerns will start to focus on the housing market and consumer activity to be the canary in the mine relative to potential economic weakness.

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Overlooked Strategies...

The proliferation of portfolio management techniques and tools that investment advisors can employ has grown dramatically in recent years. However, one frequently overlooked strategy, which offers several benefits, is often left out: closed-end funds. As is often the case in the capital markets, those areas where the "herd" is not focused can provide advantageous investment opportunities over the longer term. IMCG has applied its own valuation analysis techniques to this market for more than a decade - and many of our clients' portfolios hold one or more closed end funds currently. As such, we would like to further define these investment tools and some strategies relating to their utilization.

Unlike traditional open ended mutual funds which are constantly issuing and redeeming shares, a closed end fund has a fixed number of shares outstanding which are issued to the public via an initial public offering. As a result, closed-end funds behave more like stock than open-end funds since shares in the fund are bought and sold on a stock exchange. The price of a share in a closed-end fund is determined entirely by market demand, so shares can either trade below their net asset value ("at a discount") or above it ("at a premium"). Investor share redemption is not a concern for closed-end funds; as a result, the fund's portfolio managers can take a longer-term view when implementing their investment choices, and can elect to employ other, more sophisticated investment strategies.

Our Investment Committee focuses on the fund's underlying asset valuation and uses as one of our selection criteria the opportunity to buy the fund's shares at a discount to the value of the assets the fund owns. This provides our clients with the opportunity for potential increases in current yield, as well as more attractive entry points for longer term growth investments. Amongst other strategies, these investment tools are used to hedge the U.S. dollar, as well as develop exposure to smaller overseas and emerging markets where traditional asset allocation would be cost prohibitive.

For investors seeking income, buying a closed-end fund at a discount can also help them enhance the yield of their investment. If the fund in our example also pays a dividend, investors who buy their shares at a discount will also enhance their yield, because yield is calculated on actual dollars invested at a discount and not on the NAV. For example, assume a fund has a net asset value (NAV) of \$20 per share and a market price of \$18 a share and pays \$1 of income a year. The yield based on NAV is 5% ($\$1/\20), but because a closed-end fund yield is based on market price, the actual yield received is 5.6% ($\$1/\18).

Since the core of IMCG's investment discipline is relative valuation and cash flow production, this many times overlooked aspect of the investment universe can offer attractively priced assets producing above average income.

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Why Dividends Matter...

The clients that have been with IMCG for an appreciable amount of time know of our emphasis on cash flow; both from our investments and in our portfolios. However, the clients that have joined us more recently might not be as familiar with the reasoning behind this approach. Here is a short explanation for why dividends matter so much.

Stocks that pay a significant dividend are usually considered safe, boring investments. Owning utilities is thought of as a bond substitute. While these stocks are not considered market leaders, there are points in the economic cycle when these are the best stocks to own. The current economic conditions are perfect for these stocks.

First, consider equity market conditions. The overall market is slightly overvalued, but dividend paying stocks constitute some of the best valuations to be found. This includes many other industries outside the typical utility holdings. We have found higher than average dividend returns combined with decent value in industries such as food, pharmaceutical, finance, timber, petroleum, telecommunications, and brewing.

Next we need to look at interest rates. On June 29, the Federal Reserve raised rates for the seventeenth time in a row. As the effects of these rate hikes take hold, economic growth will slow. This is called the late period of an economic cycle. As momentum slows, economically sensitive sectors like materials and technology tend to fair badly. Utilities normally remain strong, as do consumer staple stocks - companies involved in food, prescription drugs and beverages.

The wording of the last Federal Reserve announcement leads us to believe that they are nearing the end of this cycle of economic tightening. Once the Fed is done raising rates, the market does not launch into a rally. There is normally a six-month lag between the last discount rate hike and a trough in leading economic indicators. That is when we will start to look at cyclical stocks again.

IMCG NEWS

We pleased to announce the following additions to our *Client Development & Support Group*:

CAMILLE SHIFFLER – With an extensive background in computers and administration, including teaching experience from grade school through college, we're excited about the contributions Camille has already been making to the firm as a *Client Service Associate*. Part of her management role within the *Group* will include operational oversight and client workflow monitoring.

JASON DUBAIL – Joining us with experience in the financial services industry, as well as administrative management, Jason will focus his technological skill set on the firm's database utilization, along with the responsibility for our trading platforms and portfolio monitoring applications.

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