



VIEWPOINTS

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ADVISORY NEWSLETTER

MARKET COMMENTARY

FREDRIC W. WILLIAMS

Déjà Vu All Over Again?...

"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."

-IMCG Investment Policy Committee; June 2006

We are not the type to pile on, or kick a heretofore significantly positive contributor to our economy when it is down. However, having witnessed the tech bubble of the late nineties, we cannot help but compare it to our most recent asset bubble – the residential real estate market, complete with the return of the nineties mantra "this time it's different."

We focus on this topic to determine the depth and breadth of the impact that a slowing (crashing?) housing market may have on our economy over the next six months to two years. As we've talked about in this space numerous times over the years, approximately two thirds of our GDP is consumer driven so any constraints on our spending and savings habits can reverberate throughout the economy. Since there is a high correlation between the housing market and consumer spending we would be concerned about any real estate weakness that would cause the consumer to feel compelled to retrench financially.

The bursting of the tech bubble caused consumers to reflect on their diminished 401(k) statements and pare back spending and that negative wealth effect was followed by a recession. This time, the inability of a consumer to extract equity from their home, as they have for the last 5 years, could lead to a decline in the spending that has driven our economy of late. Combine that with a negative savings rate and greater amounts of money going to pay adjustable rate mortgage payments as rates increase over the next two quarters, and you have the potential ingredients for an economic slow down.

Overlaying this commentary is some fairly compelling statistical data. With regard to a regional view of housing activity that can possibly be extrapolated to other areas of the economy where supply and demand dynamics appear to be out of balance:

"In Florida, the most extreme example of the investor frenzy may be the Miami condo market, followed closely by Naples, Orlando and the Panhandle. Right now, Miami alone has more than

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50,000 condos under development, with thousands more in the planning stages. But from 1995 through 2005, the absorption rate in Miami averaged 2,500 units per year.

When most people think of Miami, they think beaches. Unfortunately, many investors are not getting the Miami they have pictured in their mind. Most of Miami's new condos are not being built along the world-famous beach. Many so-called luxury condos are going up in some of Miami's most blighted areas. But the investors who scooped up these condos from as far away as Europe and Australia saw slick Websites and magnificent marketing materials."

Mike Morgan; Barron's September 29th 2006

August saw the first year to year price decline in the median price of an existing home since 1995 (1.7%) and was the second sharpest drop in the 40 years the data have been collected. This has been combined with the typical overbuilding by developers/speculators and is impacting new home sales as well:

"Among the news that gave the stock market a nice lift was the report that sales of new single-family homes rose 4.1% in August, to an annual rate of 1.05 million units. The rise was particularly inspiring because it was the first sign of life in housing since way back in March and manifestly raised hopes that the decline may be bottoming out. We don't buy it for a moment and neither should you.

Here's why: The only reason sales were higher, as Northern Trust's gimlet-eyed Asha Bangalore points out, is that there were ponderable downward revisions to the previous estimates of new home sales in May, June and July. If the original estimates for July were unrevised, August would have shown a decline of 2.1%, instead of a rise of 4.1%.

Asha goes on to remind that new home sales are known for large revisions. And so, she suggests, a much more reliable alternative is the three-month moving average, which, as it happens, came to 1.05 million new homes sold, the lowest since May of '03. Using that three-month average, sales of new homes are down a whopping 19.4% from a year ago.

Meanwhile, inventories continue to swell; at last count, there was a 6.6-month supply of unsold new houses, up from 4.7 months at the end of August '05. Prices, for their part, continue to do what the smart money said they never could -- go down.

Housing may have bad months and not-so-bad months. But, pure and simple, it is nowhere near hitting bottom."

Alan Abelson; Barron's September 29th 2006

The cycle of impatient and outsized investment expectations is almost as predictable as it is manic – in the late 90's "day traders" became a career rather than an avocation, as their linear projections disregarded history and valuations and became deluded with the intoxicating stew of ever increasing prices in the equity markets. When that bubble popped and the Fed flooded the street with cheap money, day trading migrated to real estate (remember "flipping" and the pre-closing sale?) with the same absence of rational valuation or demand analysis. The difference this time is that a housing correction could have profoundly more impact than the dot com crash given the related businesses dependent on the housing market.

For perspective, remember that the NASDAQ is still down about 40% from its peak, and the Dow, after 6 years, is just now closing in on its previous all time high from early 2000... imagine if those numbers played out in residential housing prices?

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

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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

Is The Summer Rally Sustainable?...

During the third quarter, domestic equity markets rode the backs of lower energy prices and a modest decline in interest rates to levels not seen since the bursting of the tech/dot com bubble more than six years ago. During trading on the last day of the quarter, the Dow briefly exceeded the it all time closing high, but just on an intraday basis. The record of 11,722.99, set back on January 4, 2000, survived as the Dow settled back to close at 11,679.07 as traders took the early trains home for the weekend. The Dow Jones Industrials rose 4.7% for the quarter, logging its best 3rd quarterly performance since 1995. The index is up 8.97% for the year. After backing and filling during the second quarter, the S&P 500 rallied 5.2% during the most recent quarter and has gained 7.01% year to date. Technology stocks came back into favor during the third quarter. As a result, the NASDAQ, with its disproportionate weighting of tech holdings, rallied 4% in the quarter. The composite now has a positive return on the year with a 2.41% gain.

The 3rd quarter advance came in the face of a weakening housing market, a related slowdown in consumer spending, and concern that a slowing economy was in our future. As discussed above, declines in housing values typically cause consumers to retrench financially and reduce consumption. Eventually, the cut back impacts corporate earnings, the revival of which has been a driving force in the 4 year market advance from the 2002 lows.

Overseas bourses surpassed US markets again during the third quarter. The majority of foreign exchanges have exceeded domestic indices through the first three quarters of the year. Three months ago, stocks in Europe and Asia were held back by fears that the central banks in that part of the world would aggressively raise interest rates. Investors' nerves were calmed this quarter. A stream of benign inflation data readings from Euro-zone countries and in Japan prompted economists to doubt central banks would be eager to increase rates quickly in the next 18 months to 36 months. Much like last quarter, the emerging markets beat their more developed brethren. China, Russia and India all booked 32% plus returns on a year to date basis, this despite the Mumbai (formerly Bombay) train bombings and the ongoing upward revaluation of the Chinese renminbi. Within the developed world, the Euro based bourses continued to outpace the US, with Frankfurt's Xtera-Dax closing the 3rd quarter up 11.34% on a year to date basis, followed closely by Paris' CAC-40 which is ahead by 11.02%. London's FTSE-100 is now ahead by 6.09% and Tokyo's Nikkie-225 reversed the profit taking from the first half of the year and move to the positive side of the ledger with a year to date gain of 0.10%.

Interesting enough (and as we have pointed out in our investment outlook for quite some time) these indices continue to trade at significant discounts to the earning multiples of our domestic equity markets. Frankfurt, Paris and London all sport price-earnings ratios of 12 to 13, while here at home, the S&P 500 trades at 18 times earnings, the Dow at 22 and the NASDAQ still valued (by whom we're not quite sure) at around 45 times forward earnings.

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As we have indicated in the past, we are much more comfortable with more modest valuation multiples as we believe that this can provide a consistent, low volatility, cash flow oriented, total return. Our playoff season analogy will be our goal of hitting a string of singles rather than swinging for the fences – our discipline aims for incremental growth rather than spectacular (and more risky) short term results:

“Given the fact that many of us with a touch of gray feel it more important to focus on the return on investment, rather than be concerned about the return of investment, it’s instructive to remember that investing in the equity market represents the acquisition of a fractional ownership interest in a company, not the purchase of a lottery ticket.”

IMCG Investment Policy Committee; October 1999

Current valuation measurements, a concern about the strength of our economy, along with the relative direction of the dollar, will continue to focus our attention on the opportunities that present themselves overseas and within our domestic defensive sectors.

BOND MARKET OVERVIEW

INVESTMENT POLICY COMMITTEE

The Pause That Refreshes?...

For the first time in more than two years, our overview of the bond market does NOT begin with a recitation of increases in fed funds target by the F.M.O.C. during the previous quarter. Chairman Bernanke & Company did not take the summer of 2006 off, in fact they met twice. They decided to leave the federal funds rate target unchanged during the quarter, saying the cumulative effects of its 17 increases since June 2004 would likely slow the economy and curb inflation. U.S. Treasuries had their biggest quarterly price gain in four years as evidence accumulated that the economy is slowing.

The benchmark 10-year note's yield declined more than half a percentage point as expectations that the Federal Reserve would raise interest rates further gave way to the view that it may lower them in the coming months. The yield, which moves inversely to the note's price, rose at the end of the quarter on stronger-than-expected reports on consumer confidence, home sales and Midwest manufacturing.

The 10-year yield touched a seven-month low of 4.53 percent on Sept. 25, down from 5.14 percent on June 30 and it ended the quarter at 4.63 percent. Including price gains and accrued interest, Treasuries returned about 3.65 percent since midyear, with their biggest previous quarterly return being 7.2 percent in the third quarter of 2002. Although still in some ways inverted, the yield curve is indicating a belief that a slowing economy will once again force the Fed to reduce short term rates in the next few quarters.

The Commerce Department reported that personal spending rose a seasonally adjusted 0.1% in August from the previous month to \$9.36 trillion. That was the lowest rate of growth since November and much slower than the 0.8% gain in July. Adjusted for inflation, consumer spending actually fell 0.1% in August. This is the first inflation-adjusted decline since September 2005, when business activity was disrupted by Hurricane Katrina. Analysts said spending was curtailed by declining auto sales, the continuing contraction in the housing

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market and gasoline prices that topped \$3 a gallon in early August. Personal income rose a seasonally adjusted 0.3% in August to \$11.05 trillion. That followed a 0.5% gain in July. Income growth was the weakest in nine months, reflecting sluggish wage growth in August when job creation was modest. The core personal consumption expenditures price index -- which excludes more volatile food and energy costs and is the key inflation gauge followed by the Federal Reserve -- rose 0.2% in August from a month earlier and 2.5% overing the trailing 12 months. That is the highest year-over-year reading since April 1995, and remains above the 1% to 2% comfort zone preferred by many Fed officials.

The proverbial elephant in the room at this point is the housing market. How the current decline plays out, primarily in its severity and duration, will determine the shorter term direction of rates and the ultimate condition of the economy in the coming year. As noted in the first portion of this commentary, housing played a large part in the recovery and could have an equally significant impact in decline. During the expanding housing bubble the industry represented about 1/3 of the new jobs created; the industry is highly correlated with GDP so a housing market in free fall doesn't bode well for near term economic growth. Our objective will be stay on the sidelines until we get a sense as to how this bird plans to land -- like a gently deflating hot air balloon or like a parachute that neglected to open.

WEALTH MANAGEMENT UPDATE

TRACY W. ROGERS

Recent Pension Reform...

On August 17, the Pension Protection Act of 2006 was signed into law by President Bush. Industry analysts expect the law will lead to the expansion of 401(k) and IRA accounts. Over 900 pages in length, the new legislation reflects the move by many employers away from traditional defined benefit (DB) pension plans and toward defined contribution (DC) plans. Its provisions also highlight governmental concern over shaky financial conditions of many DB plans and the potential adverse effect that any future defaults by plan sponsors will have on the federal government and, inevitably, the American taxpayer.

The following are highlights of a few of the notable provisions of this new legislation. Some of these changes may directly benefit you or your employees. We would encourage a portfolio/wealth management review to see how these may affect your planning process.

The Act makes permanent a number of retirement plan and IRA changes that were added to the tax laws in 2001 but were set to sunset after 2010. By making the 2001 changes permanent, the new law preserves the advantages of higher employee contribution limits for employer plans, higher IRA contribution limits, more flexible plan rules, portability, a catch-up for those over 50 and an increase in employer contribution limits. For example, it locks in continued increases to the maximum amount workers can contribute to 401(k) accounts and IRAs.

In addition, the Act guarantees that gains from 529 college savings plans will remain exempt from federal taxes, a provision that had been set to expire in 2010. The new law also makes

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permanent the saver's credit, which was set to expire after 2006. After 2007, the income limits that establish eligibility for the credit will be indexed for inflation.

Beginning in 2007, the Act also permits qualified "fiduciary advisers" to offer investment advice to help employees manage their 401(k) and other retirement options, subject to certain conditions. Additionally it puts in place fiduciary and disclosure safeguards to ensure that advice provided to employees is solely in their best interest and provides protection for fiduciaries for "default" investments when participants fail to provide investment directions.

Provisions in the Act that liberalize plan payout and rollover rules include the following:

- Employer contributions to defined contribution plans, such as 401(k)s, must vest at least as quickly as the three-year cliff or six-year graded schedule, beginning in 2007;
- After 2007, taxpayers will be permitted to make direct rollovers from qualified plans to Roth IRAs;
- For purposes of the 401(k) hardship distribution rules, "hardship" includes hardship of any beneficiary under the plan (not just a spouse or dependent);
- Members of the National Guard and Reserves called to active duty through 2007 can make penalty-free withdrawals from retirement plans. Withdrawn amounts may be repaid to the IRA or pension plan within two years of the distribution;
- The 10 percent early withdrawal penalty for distributions to public safety employees over age 50 (including police, fire, and emergency medical services) who may retire early is waived for distributions after August 17, 2006;
- Effective for post-2006 distributions, non-spouse designated beneficiaries are allowed to make rollovers of inherited amounts in qualified plans, governmental Sec. 457 plans or tax-sheltered annuities to their own IRAs (treated as inherited IRAs); and
- Effective for distributions in plan years beginning after 2006, defined benefit plans can make in-service distributions to age-62-or-older participants.

It is important that we discuss these changes with you and see how they may affect you and your unique situation at your next portfolio and planning consultation review.

For example, it may be time to revisit the use of 529 plans for college savings given the previous concerns about the tax implications prior to these revisions. For employers/plan sponsors it may be time to revisit the structure of your retirement plan (401k, Age Weighted Profit Sharing Plan, SIMPLE, etc...) and determine if it is best serving the needs of you and your employees. As part of our wealth management process we can advise/implement/monitor workplace retirement plans, and we can serve as fiduciary advisors and advocates for the plan sponsor/trustees and their employees.

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Risk Adjusted Returns...

The headlines about Amaranth Advisors in the Wall Street Journal seemed preposterous: "Hedge fund down \$6.5 billion in less than a month;" "Trader's losses total \$5 billion for the week." How could anyone lose that much money that quickly? The explanation is less exciting than one would expect and the lesson has applications for any size investors in any marketplace. What is astounding is that a fund aimed at "sophisticated" investors would make so many elementary and ignorant decisions.

Amaranth, which is in the midst of closing its operations, was a hedge fund in Greenwich, CT known for trading convertible bonds. But then the profitability of "convertible arbitrage" largely dried up. Rather than close down, Amaranth diversified into other asset classes, notably energy futures. For two years this worked out well and more and more of the fund went into energy. By the time the fund blew up in September, somewhere around 50% of its assets were involved in a simple bet the price of natural gas would rise. There was no risk management through diversification.

The overriding lessons are simple. First: risk and reward always belong together. Historical gains (or returns) of an asset or portfolio are often extremely misleading and to fixate on returns will cause poor judgment. The management of the fund was too blinded by the gaudy returns to drill into the numbers and see at was producing them. That is what is meant by risk adjusted returns. Gains can not be considered in a vacuum. Gains result from price movements, or volatility. Bigger gains result from larger volatility. In Amaranth's case, the energy trader made \$2 billion in August. And then lost \$4.5 billion in September.

Risk is not the danger of missing the next rally. It is not missing buying Google at its low. That is speculation, which has its place. The risk in investments comes from variability of return. The greater the variability, the greater the risk. The assumption in the markets is that investors are generally risk averse, so investments with greater unpredictability must hold the promise of greater reward. This extra return is the "risk premium." So return is invariably a function of risk (as I mention at least once a month). Any profit earned should be viewed in the context of the risk taken.

Before you can evaluate the performance of your own financial assets, you must look at the risk adjusted returns. This involves another investment term -- beta. Beta measures the relative stability of an investment to the market as a whole. If for a market move of 10% a stock consistently moves 15%, it would have a beta of 1.5. In practical terms, new issues and small cap growth stocks have a high beta. Larger stocks, particularly undervalued ones and utilities are more stable and have a lower beta.

As Warren Buffett put it, "Risk comes from not knowing what you are doing." So we stick closely to our disciplines. Risk is inevitable in investing as in all things. Even burying your cash in coffee cans in the backyard means transferring its purchasing power from today until

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the day you dig it up. Adjusting returns for the risk taken may prove a higher return often is not superior to a lower one. The goal is to the risk/reward tradeoff for each unique investor. This is more complicated than it sounds – but only when it is done correctly.

IMCG NEWS

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

COREY HAMILTON – Joining us from Lincoln Financial Group with an extensive background in computers and retirement plans, we're excited about the contributions Corey has already been making to the firm as a *Client Service Associate* focusing on our client financial planning processes and software.

WORKSHOPS & SEMINARS – Keep an eye on your email and snail mail as we'll be scheduling a series of investment, wealth management and planning seminars with our colleagues in the legal and risk management community. The dates should be posted with the next few weeks – and we look forward to seeing you there!

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