



VIEWPOINTS

4TH QUARTER 2006

ADVISORY NEWSLETTER

MARKET COMMENTARY

FREDRIC W. WILLIAMS

The New Fox in the Hen House?...

During the leveraged buy-out boom of the 1980's, the assorted *Barbarians at the Gate* were epitomized by the Gordon Gekkos of the world, and vilified for the manner in which they extracted capital from companies by assuming large amounts of debt to finance the acquisition, and then aggressively cutting expenses (i.e. personnel) to make sure the bills could be paid. In the '90s this market participant morphed into what appeared to be a much more cultured and altruistic *venture capitalist* who helped bright idea people capitalize on their ideas through initial public offerings...eventually taking the bulk of the equity, as well as control of the company, as payment for their services. At the start of this new millennium, and after the tech bubble burst, the next iteration of these players to gain visibility were the *hedge funds*, promising above average returns for sophisticated investors...like the ones in Long Term Capital Management and Amaranth.

This year, as the cost of capital continues to be far less than the return on capital it could generate, the new belle at the *Predators' Ball* appears to be the private equity funds and the cache of cash they have to deploy around the globe (although predominantly in the U.S.) as they seek out "undervalued" companies to invest in. Much like their ancestors from the "old days" they look for companies with lots and cash and little debt, so they can pay themselves by turning the companies in to the antithesis of what they found – companies with lots of debt that is used to pay "dividends" to their new owners.

To some observers, the surprising speed with which they've been able to turn around these companies and cash out with significant profits by selling the company back to the same people they had bought it from 1-3 years before, John and Jane Q. Public, has led some to question the original buy out valuation that "management" agreed to:

"Shareholders are beginning to see the money they're leaving on the table and demanding more from companies. Boards of directors are under pressure to push back against buyout firms...Companies are also starting to mimic private-equity tactics -- add debt, subtract equity -- in search of better returns. The Justice Department, meantime, lurks in the background, probing whether buyout shops are colluding to keep bids artificially low...

"Today, if there's a controlling or important shareholder in play, he's probably already working with the buyout group. All too often management is too, and it's being paid amply for its

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cooperation. Remaining shareholder bases are typically too dispersed to organize against suboptimal offers, or too complacent to demand more." - Dennis Berman, Wall Street Journal 1/2/2007

Above and beyond the potential fiduciary concerns raised from this perspective, there is also a question about what impact the movement of this excess liquidity around the globe has on the variety of financial markets it is allocated to:

"Riskier assets, such as emerging-market debt, are priced at only a small margin above much safer Treasuries. The same goes for junk-rated corporate debt. Corporate debt defaults in the U.S. are at record lows -- just \$1.2 billion in 2006, one-fifth the already low level of just one year ago, according to Standard & Poor's Leveraged Commentary & Data.

"The balm of cash has also quieted the stock market. Market volatility is exceedingly low. Emerging market stock markets are roaring, up 230% as a group from lows reached in 2003, according to data from HSBC PLC.

"The riskiest markets are leading the pack: Egyptian stocks are up 14 fold since 2003. Meanwhile, money in alternative investments -- hedge funds, private-equity funds and the like -- now totals \$3 trillion, according to data from J.P. Morgan Securities.

"All that liquidity, or cash, available has pushed financial assets to heights world-wide and driven investors into riskier corners of the market in search of better returns."

- Henny Sender, Wall Street Journal 1/2/2007

As value investors we prefer to buy things cheap and sell them when they're dear – an arguably challenging valuation analysis given the variability that can be brought to bear on a study of differing companies, sectors and countries. One thing that we are comfortable with is the idea that if the owner of the hen house is moving his chickens elsewhere, you might want to look into some alternate accommodations. In this case we would reflect on the action of corporate insiders:

"...As a rule, officers, directors and other so-called insiders typically sell more than they buy. But nowhere near to the extent they did in the latest month tallied -- November.

"As Alan Newman notes in his always rewarding CrossCurrents commentary, in November, those worthies, as totted up by Thomson Financial, dumped an astounding \$16 billion worth of their stock, or nearly 35 times as much as they bought. By comparison, in the 11 months beginning December '05 and ending October '06, the ratio of sellers to buyers among insiders averaged 10.7-to-1.

"The early returns for December are even worse: in that month's first two weeks insiders collectively sold 55 shares for every one they bought. As Alan comments, they were so bound and determined to take money off the table that they couldn't even wait the few weeks until January to avoid the serious tax bite for what probably was a pretty lush year for them in '06. "What," he asks, "does that tell you?" We're terrific at answering rhetorical questions, and the answer to that one is "plenty."

"So who's buying those billions of dollars worth of shares the insiders are selling? Alan speculates that the latest Wall Street wonder, exchange-traded funds -- or in the lexicon of the Street, ETFs -- has been sucking up a lot of that stock gushing out of insider portfolios.

"By his reckoning, through mid-December, last year's net issuance of ETF shares weighed in at a massive \$54 billion, extending a smashing seven-year growth that has averaged an awesome 41% annually and has lifted the total value of such shares to close to \$400 billion. It's critical to remember, Alan points out, that for an exchange-traded fund to issue shares it must first buy the

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underlying assets, primarily stocks. That demand all by itself, he reckons, was enough to keep the market rally of the past few months alive and well.

"Not the least interesting thing about ETFs and their powerful impact on market prices is that they don't trade on the basis of individual corporate prospects. Alan posits that more than half the price of many stocks is now dependent on "index or sector sponsorship, the obvious result of a market that has been increasingly sectorized to death and indexed beyond any efficiency" imagined by academics. For ETFs, in other words, valuations don't matter.

"Which is the dangerous message he gets from the fact that the top 10 constituents of the most popular ETF, the Nasdaq 100 Trust, which trades a formidable \$4.7 billion a day, sport a P/E north of 33 and are selling at over six times sales.

"Unless we're willing to say history and, for that matter, logic are bunk, it's plain as the nose on your face that valuations do matter. That's what investors should have learned from their sorry experience in 2000, reflects Alan, and what they very well may learn again the hard way when this market turns tail."
- Alan Abelson, Barron's, 1/1/2007

Above and beyond the fact that those who should know the most are selling their company's shares as fast as they can, the practical impact of this superbly articulated perspective would come into play should the demand side abate. If the aforementioned Mr. & Mrs. Public are less inclined to invest (due perhaps to a thinning relative wallet resulting from declining housing values, as an example) then the buyers of the shares sold by insiders (the ETFs) would be less inclined to step in to the breach – perhaps allowing the market to drift lower in this particular illustration.

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

Dow Record Above 12,500...

Global liquidity, resulting from accommodative interest rates, continued the domestic equity market's advance through the 4th quarter, with the Dow hitting new highs, and closing above the 12,500 level, during December. The plethora of private equity transactions, combined with the fact that the NASDAQ and S&P 500 did not confirm these highs, could cause some to ponder either the durability of the advance, or the relevance of the index, particularly when viewed within the context of recent market history. So the question is whether this year-end rally was much ado about nothing, or a canary in the mine of another form of irrational exuberance:

"All of which gives us a strong sensation of déjà vu and, more particularly, why this glorious new year of 2007 seems so much like the not-so-glorious year of 2000. As we remember, 2000 began amid enormous euphoria, with the stock market headed for the moon. While the rationalizations at the time from the good-cheer incorrigibles of why the market was neither pricey or risky differed from the current versions of why the market is, if anything, undervalued, the reasoning is as flawed now as it was then.

"As we also remember, 2000 ended in tears and tears that kept flowing for a long couple of

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years. So keep a generous store of hankies at the ready and hope the denouement to the current manic mood doesn't do quite as much damage to your psyches, let alone your pocketbooks. We were about to say, Happy New Year!, but maybe we'll wait for a more propitious juxtaposition to do so."

- Alan Abelson, Barron's 1/1/2007

Not that we want to rain on the parade of the best equity performances since 2003, but we're reluctant to believe that it is different this time, that the contribution on the upside that housing provided won't have similar impact on the downside, or that the insider selling which hit all time highs in December was being perpetrated by rogue executives who know nothing at all about the companies they run. Although we continue to be committed to the domestic equity allocations we presently have in place, we're a bit less sanguine than the apparently euphoric dollars that chased the private equity deals through the end of 2006.

To be sure, the markets were stronger last year than most expected, with the Dow up 16.3% for the year, the S&P 500 up 13.6% and the NASDAQ advancing 9.5%. Two somewhat surprising sub-sector moves in 2006 occurred within the utility (DJUA +12.8%) and REIT (up 29% according to SNL Research) markets. With pension plans looking to shore up their long term obligations in an environment of relative low interest rates, there has been demand for infrastructure investments that combine tangible assets with the potential for increasing future cash flows over longer periods of time. To this end, allocations in everything from airports to toll roads, and power generation facilities to municipal water networks have been privatized, pushing up the valuations for the entire sector. Likewise, the aforementioned capital markets liquidity has fostered mergers and buy-outs within the REIT sector throughout the year, culminating in the \$20 billion purchase of Equity Office Properties by the Blackstone Group in November.

Internationally, the developed world's markets were fairly consistent with their brethren stateside as Frankfurt's Xtera-Dax closed 2006 up 22%, followed by Paris' CAC-40 which was ahead by 17.5%, London's FTSE-100 gained 10.07% and Tokyo's Nikkie-225 followed 2005's stellar performance with a more modest increase of 6.9%. As has become the case over the last couple of years in this less risk-adverse environment, the emerging markets were where the moon shots were in 2006. Venezuela's IBC General leapt 156.1% (in local currency terms), while China's Shanghai A jumped 130.6%, followed by more "subdued" returns from Indonesia (JAX Composite +55.3%) and Mexico (IPC All Share +48.6%), highlighting the fact that the more aggressive overseas plays benefited from the previously mentioned global liquidity, as well as developing domestic demand for their own products. The rub here is that weakness in the dollar could erode the American consumer's ability to be the buyer of last resort for economies that are solely dependent on exporting to the U.S. economy – although still attractively valued on a relative basis, the emerging market's run up will require monitoring as we move through the new year.

Although continually evaluating opportunities domestically, we see 2007 as another year to maintain, and develop, our equity and debt exposure overseas (primarily in the developed world) where more reasonable valuations can be found and the opportunity to hedge, as well as take advantage of, a weaker dollar will exist.

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Waiting for Bernanke...

As we pointed out last quarter, our observations again this time do not start off with an overview of the increases in federal funds targeted by the F.O.M.C. Instead, the continuing debate centers around what next that Chairman Bernanke & Company will do with short term rates as we proceed through the new year. The various points of view center on whether rates will go up (inflation; weakening dollar), go down (housing declines; slowing economy) or remain the same (the Goldilocks School of Economics). It may not be which perspective wins out in 2007, but instead could be a function of *which* is correct *when* over the course of the coming year.

The 10-year yield closed the year at 4.708%, up from 4.393% at the close of 2005, but down from the mid year high of 5.25%, as abating oil and commodity price pressures combined with a slowing housing market to ease some of the inflationary concerns. With 6 month T-Bills yielding 4.9%, the 2-year note at 4.82% and the 30-year bond at 4.79%, the yield curve remains inverted, an early warning sign to those who believe this condition portends a recession. As previously touched on in our observations of the emerging markets, a lack of apparent investment risk adversity here at home moved the spread between high yield corporate bonds and Treasuries to 2.82%, down from an already low 3.71% at the end of last year. With investors focused more on the return *from* their assets, rather than the return *of* their assets, it would appear that valuations afforded high yield debt offer more downside, than upside, return potential over the next year.

As expected, how these dynamics play out will be a function of what actually happens in the economy going forward:

"On average,...economists predict that inflation-adjusted gross domestic product, a broad measure of economic activity, will grow at an annualized rate of 2.3% in the first half of 2007 and 2.8% in the second half. That's up from a sluggish 2% in the third quarter of 2006, but still far below the robust annual growth rates of 3.2% for 2005 and 4.1% for early 2006.

"The upbeat attitude in services contrasts sharply with the recent pain in the housing and manufacturing sectors. Builders have been slashing prices and production as they attempt to get rid of a large backlog of unsold homes. Despite a rise in November, new-home construction was down 30% from its January peak.

"Housing-related industries shed 145,000 jobs from May through November, according to Zoltan Pozsar, an economist at Moody's Economy.com. Falling home values have also left people with less power to extract cash from their homes through home-equity loans and refinancings, a factor that many economists expect to take a bite out of consumer spending.

"Along with slumping auto sales, the drop in housing activity has affected all kinds of manufacturers, from drywall factories to furniture makers. The Institute for Supply Management, a purchasing managers' trade group, said that its index of manufacturing activity for November fell to 49.5, the lowest point since April 2003. (Any number below 50 indicates contraction.) By contrast, the ISM's index of service-sector activity for the same month rose.

- Mark Whitehouse, Wall Street Journal 1/2/2007

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Given the headwinds from weakness in the housing market, the potential for a slowing economy, and the impact that a weaker dollar may have on the inflation front, we will continue to be at the short to intermediate end of the yield curve where we have the most flexibility in adapting to which scenario(s) comes to the forefront at differing times in our new year.

WEALTH MANAGEMENT UPDATE

TRACY W. ROGERS

Portfolio Strategies and Year End Tax Updates...

With the media focused on the condition of the economy, the future direction of interest rates, all of the talk of inflation/stagflation, and the weak dollar, we thought this would be a fortuitous time to discuss inflation linked bonds, their foreign brethren, and the underlying portfolio strategies that are the basis for these allocations.

After two decades of declining interest rates and inflation, we observed an inflection point approximately two years ago with the Fed beginning to move short term rates higher amidst concern about accelerating inflationary pressures. For traditional bond owners, this environment is an anathema to their portfolios as rising rates can depress the value of fixed income investments. Many of our clients hold some sort of inflation linked bonds in their portfolios as a hedge against this scenario, be it U.S. government issues (Treasury Inflation Protected Securities, known as TIPS) or overseas sovereign (government) debt. As is the case with dollar denominated TIPS, these foreign bonds are aimed at helping investors preserve the purchasing power of their money over time by having the maturity value of the bond indexed to the increases in the country's level of inflation. In addition, these foreign bonds, given that they are denominated in other currencies (Euro, Pound Sterling, etc.) have the added benefit of generating higher returns if the dollar continues to fall.

Within our portfolios, owning these domestic, or overseas, inflation linked bonds is a strategy to protect against a weakening dollar and rising interest rates, which can be spurred along by budget and trade deficits. These bonds are also a way to guard against potential global inflation, given the rising commodity prices we've recently experienced around the world, while offering the added benefit of providing portfolio diversification across more than one measure of inflation.

As previously mentioned, these instruments provide a so-called real return, or a return above the rate of inflation. This is accomplished by having a regular adjustment to the bond's underlying principal value based on a measure of inflation. Thus if inflation rises, so does the bond's principal amount, as well as the bond's interest payments, since the coupon amount is applied to the higher principal balance each period.

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Contribution Tables

As we prepare for a new year, below please find an updated list of contribution limits for various retirement plans going forward:

<u>Plan Type</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
<i>IRA</i>	\$4,000	\$4,000	\$5,000
<i>- Over 50 Catch Up</i>	\$1,000	\$1,000	\$1,000
<i>Roth IRA</i>	\$4,000	\$4,000	\$5,000
<i>401(k) Salary Deferral</i>	\$15,000	\$15,500	\$16,000
<i>- Over 50 Catch Up</i>	\$5,000	\$5,000	*Indexed for Inflation
<i>SIMPLE Salary Deferral</i>	\$10,000	\$10,500	*Indexed for Inflation
<i>- Over 50 Catch Up</i>	\$2,500	\$2,500	*Indexed for Inflation
<i>403(b)/457 Salary Deferral</i>	\$15,000	\$15,500	\$16,000
<i>- Over 50 Catch Up</i>	\$5,000	\$5,000	*Indexed for Inflation
<i>Coverdell IRA</i>	\$2,000	\$2,000	\$2,000

INSIDE THE MARKETS

FRANCIS J. DAVIES III

Integrated Portfolio Management...

It has now been a year since my clientele and I joined forces with IMCG. The move was not a simple decision. Change is never easy, particularly when it involves shifting the life savings of many people to a new home. The mountain of paperwork alone was enough to make me reconsider. The fact that this was the right choice has become more apparent each day.

I have always been able to deliver a very good rate of return on my clients' assets. But I wanted to offer my clients more than just solid investment results. They required a complete financial service program. IMCG offered me the expertise necessary to match the correct portfolio strategy to the unique circumstances of each of my clients. This holistic approach takes your entire financial picture into consideration and addresses it in an organized fashion. It is definitely "integrated portfolio management".

That is why the client data form is such a vital part of the process. Through this inventory we get to know you and your goals. You tell us what you will need to address – whether it is caring for parents or providing for grandchildren. We examine how needs and assets fit together and discuss your time horizon.

With this knowledge, we can craft your portfolio to complement your other assets. This is particularly the case when we look at asset allocation. Proper diversification means we need to avoid replicating an investment held elsewhere. Over concentration in any one area could decrease the overall stability of your holdings.

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This is true even if the assets are in a tax deferred account, such as a 401K. If we know the allocation of the assets in your retirement accounts, even if we are not managing them directly, we can use that information to better balance your overall finances.

As my clients have seen, familiarity with their overall holdings helps with tax planning. Losses or gains taken elsewhere, or tax loss carry forwards are critical for well thought-out year end tax planning. A conversation with a client's accountant revealed that the client had been carrying a fairly large tax loss for several years. The loss allowed us to sell a few greatly appreciated positions and re-diversify their portfolios.

The client's need for cash flow from the account is also a critical piece of information. We can anticipate the withdrawal and tailoring the investments so the money is available. The withdrawals could be something simple, like a one time purchase. Or it could be more complicated, such as funding college tuition. This concept of planning and anticipating continues on in a much grander scale when doing retirement planning. Or reviewing insurance coverage. Or preparing an estate strategy.

All these are the services available to the clients of IMCG. The nice part is, the cost is included in the basic *Advisory Fee*, so be sure to make use of all of them.

IMCG NEWS

JEANNINE PLOURDE – We are pleased to announce that Jeannine has joined our *Client Development & Support Group*. The firm looks forward to her background in banking and customer service adding to the team's efforts as a *Client Service Associate*.

CAMILLE SHIFFLER – As a result of her exemplary contributions over the last year, Camille has been promoted to Manager of the *Client Development & Support Group* and will oversee the team's workflow with client projects, as well as the office's administrative coordination.

FRED WILLIAMS – At the Dream Factory's national convention in Florida this fall, Fred accepted another one year appointment as the Chair of the Finance Committee for this children's organization which is based in Louisville. On a local level he was re-elected as Board President for the Dream Factory's Portland Chapter, will continue to serve this year as Treasurer of The Community Television Network, and will be terming out after six fulfilling years as a Trustee of 75 State Street, the last three as Treasurer.

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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