



March 31, 2009

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## 1st Quarter 2010

### Winning by Not Losing

Given a choice of (1) participating in the best days of the market or (2) missing them altogether *along with the worst days* of the market, which would you choose?

In a study conducted over 25 years of S&P 500 index history, the answer is surprisingly consistent. Investors don't need to participate in the best days of the market if they can miss the worst days. Missing both the best and worst 10, 20, 30 or 40 days of the S&P 500 returns outperforms the index by more than 1% annually. Over the 25-year history of the study, that 1% is the difference between a \$100,000 investment turning into \$673,836 versus \$846,624 – a \$172,788 or 25% increase in value.

**S&P 500 – 25 Years Ending Dec. 31, 2009 – Average Annual Return 7.93%**

	Miss the Best	Miss the Worst	Miss Both Best and Worst
<b>10 days</b>	4.83%	12.14%	8.92%
<b>20 days</b>	2.79%	14.74%	9.28%
<b>30 days</b>	1.12%	16.93%	9.56%
<b>40 days</b>	(.46%)	18.86%	9.67%

Source: Hepburn Capital Management 2009 Study

With that said, keep in mind this is a hypothetical example and there's never been an investment strategy that missed just the best and worst days of the market. This study also doesn't take into account management or trading fees that might be incurred in implementing such a strategy. Nor can you invest directly in the S&P 500 index.

What this example does demonstrate is how important not losing can be to an investor. 2008-2009 was a perfect example. The average mutual fund was up 34.9% in 2009 according to Morningstar. Unfortunately the average loss in 2008 was -40.5%, again according to Morningstar data. At the end of 2009, despite one of the best years for the S&P 500, the average mutual fund was still down -19.7% from where it started in 2008. If that doesn't seem to add up, you need to do the mathematics of gains and losses. A 40.5% loss needs a 68% gain to make it back to breakeven because you are starting from a much smaller balance.

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## Estate Tax Consequences Still Exist

So far, Congress has failed to reenact estate taxes for 2010, but that doesn't necessarily mean no tax consequences for heirs in 2010.

Yes, estate taxes and generation-skipping transfer taxes were repealed at the end of 2009. Without Congressional action, they will be back in 2011 at rates from a decade ago of \$1 million exempt from taxes and 55% taxes on the remainder. While Congress could pass estate taxes retroactive to January 1, 2010, the more time that passes from the start of the year, the messier that becomes to implement.

Barring new legislation, where taxes still come into play for a 2010 estate is cashing out an inheritance. Items sold from a 2010 estate will be taxable based on their original price. Inherit 1,000 shares of Amazon purchased in 1997 for \$18 and sell them today for \$130 per share, and you will have taxable gains of \$112,000. At the 15% capital gains tax rate, \$16,800 could be payable in capital gains taxes on the inheritance. As a result, individuals who might not pay estate taxes under even a \$1 million exemption, may find themselves with a taxable inheritance.

The real problem for estates in 2010 will be wills designed to pass as much of the estate through tax free as possible. For example, a will might state that 100% of the estate that could be passed on tax-free be distributed to a designated charity while the remainder goes to the surviving spouse. Today, that could mean nothing for the surviving spouse.

## Another Look at the Numbers

*'There are three kinds of lies: lies, damned lies, and statistics.'* --- Mark Twain

How bad is the housing market? Last fall, First American Core Logic reported that 23% of all mortgage borrowers owed more than the actual value of their home while another 5% were near negative equity share. However, according to *The Wall Street Journal*, some 24 million Americans own their homes outright. When that number is taken into account, the number of homeowners in danger of defaulting on underwater mortgages drops to 15%. Still a problem, but much less of one.

Unemployment, on the other hand, looks considerably worse when you look at what's behind the numbers. Widely reported is the official unemployment rate of 9.7% or 14.9 million unemployed for February 2010. The U.S. Dept. of Labor, Bureau of Labor Statistics has another number that looks at a wider population of those individuals who would like to be employed full time, but for one reason or another are not. It ranges from 17-18%, nearly double the official number. Converted to people, that's 26 million people.



The U.S. federal government deficit has become too big to grasp as a single number. One way to put it in perspective is to look at the deficit per person, based on an estimated population of 308,000,000. Each citizen's share of this debt is \$40,790. Then there's a nasty little oversight called unfunded liabilities. The federal and state governments have made a lot of promises to retirees and federal and state employees with respect to retirement benefits. Unlike businesses, they are not required to carry those promises on their books as future liabilities.

Unfunded promises by state and federal governments are in excess of \$59.1 trillion, an amount equal to \$516,348 for every U.S. household. Medicare, Social Security and federal retirement programs account for 85% of taxpayer liabilities. State and local government retirement plans account for much of the rest, reported *USA Today* in 2007. The number has not gotten smaller.

What should you do? If it's not too late, you might want to look for a job in the federal government. While state governments have made many of the same promises, their inability to print money tends to put a ceiling on overspending.

On a more serious note, the financial stresses on state and local governments are forcing the public sector to become more efficient, to cut staffs and re-examine unsustainable benefits in light of declining tax revenues. Just as corporations are forced to undergo periods of self-examination and rethink the best way to do the job and compensate employees, state and municipal governments are now doing the same. This is a very positive result of a difficult economic period and one that could have a lasting impact on local government. Whether or not the federal government follows suit remains to be seen. Its ability to borrow on a global scale is unmatched at the state level, where tax revenues shape budgets.

But at some point, even the federal government has to pay its debts. President Obama has suggested doing so by taxing the rich. Here again, you need to look at the numbers. According to the Tax Policy Center, there are an estimated three million taxpayers with annual income in excess of \$250,000. With respect to combined household income, some 2% of U.S. households are estimated to report adjusted gross income of more than \$250,000 to the IRS. They currently pay 43.6% of all personal federal income taxes.

To generate sufficient dollars from these taxpayers to pay down a deficit estimated at \$9 trillion over the next ten years, would require boosting the average federal income tax rate for households earning over \$250,000 to 69%, says the *Wall Street Journal*. Add on state income taxes from 5-15% and top earners would take home 26-15¢ of every dollar in income. For an individual earning \$250,000, take home pay would fall to \$65,000 to \$37,500. At that point, one would be much better off earning less and paying taxes at a lower rate.

Numbers can be used to blur the truth as well as clarify facts. Before you accept an argument based on statistics, take another look at the numbers.

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<sup>2</sup>Taxpayers on the hook for \$59 trillion," *USA Today*, Updated 5/29/2007.

<sup>3</sup>" Taxing Rich Wouldn't Close the Gap, but Would Shrink It," by David Wessel, *The Wall Street Journal*, Sept. 3, 2009.

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### Securities Market Commentary 1<sup>st</sup> Quarter

The first quarter may have lacked the excitement and volatility that some investors thrive on, but those who remained on the sidelines were left behind. The Dow Jones Industrial Average posted its best first-quarter performance since 1999, while the 5.9% return posted by the S&P 500 Index in March was its best monthly showing since last August. Investors who were waiting for a sizeable pullback missed another upward move, and we remain optimistic that the recent upward trend could continue.

Although pullbacks are overdue, and will undoubtedly occur, we believe they will be smaller than what we saw in 2008. Whispers about a double-dip recession, a possible correction, and prolonged malaise in the real estate sector were not loud enough to take the market out of rally mode. Economically speaking, slow and reasonably assured growth seems to be the order of the day.

Earnings reporting season is kicking into high gear and will likely drive the market in the large part over the next few weeks. Now that businesses have moved from improved bottom-line numbers to improved top-line numbers (for example, they've kept costs low while demand for goods and services continues to increase), analysts are looking for a fairly positive reporting period. Additionally, the ratio of negative pre-announcements has been lower than usual – suggesting that earnings should largely meet expectations.

March's ISM manufacturing index came in at a very strong 59.6, while durable goods rose by 0.6% in February, creating the tenth advance in the last eleven months. Data showed personal spending up 0.3% for February, even though personal wages were flat. Inflation is still minimal as the CPI inched up 0.1%. In fact, core CPI rose just 1.3% from February 2009 to February 2010, marking the tamest core inflation we've seen in six years. As a result, the Federal Reserve reiterated that interest rates would remain low for an extended period.

The major focus continues to be on the labor report, which showed much-welcomed job gains of 162,000 even though the unemployment rate stayed at 9.7%. However, as has been the case lately, the data was a bit murky, and the debate continues as to whether the Census hiring and weather impacted the numbers.

The improving economic data has allowed the Fed to slowly remove the quantitative easing measures they put into place during the height of the financial crisis. Earlier this year they ended their purchases of Treasury securities, and at the end of March they stopped purchasing mortgage-backed securities. Now we are watching to see if the economy can continue to improve without these extreme pillars of support. Excessive government debt and fiscal policy implications for economic growth have impacted market volatility, and rating agencies continue to warn about downgrade risks not only in the euro-zone, but for the AAA-rated United States and United Kingdom as well.

We would like to thank our clients for their support through a successful quarter. The CIMCO team is looking ahead with caution and confidence as we navigate these many "landmines" that may hinder continued market growth.

*Our job is to balance those risks; to invest with a strategy designed to limit losses, but still participate in the market when we see opportunities.*

## What's Different Today?

In the last year, the U.S. financial market has rallied nearly 70% and the prognosis for 2010 is increasingly bullish. But before you decide it's time to throw yourself head first into equities without a safety net, you need to answer the question – What's different today to give the market reason to continue its upward move?

We would hazard to say that the biggest difference between October of 2007 when the market started its last drop and today is that we have a better idea of the extent of the problem facing the U.S. and global economies. But that knowledge doesn't give us greater confidence in the staying power of the current rally.

Rose colored glasses say the economy is fixed and we just have to wait for growth to kick in. Low interest rates, bank bailouts, stimulus spending, and actions of the federal government are working. Unemployment is a lagging indicator, so nothing to worry about. And if there is a problem in sight it's the specter of inflation, which tends to be good for the stock market.

That's not a scenario we are comfortable with.

The problems that caused the market slide that began in 2007 are still with us. New company formations and stock offerings are still at all time lows. Uncertainty in the business community over future regulations, costs and taxes has not been resolved. The continuing constriction of tax revenues at the local, state and federal level is forcing changes in government budgets, services and unfunded programs. California is a bell weather state once again but this time on how to avoid bankruptcy.

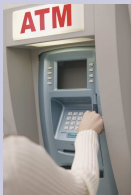
There has rarely been a more important time to have risk management a part of your investment approach. As our cover story shows, minimizing losses is extremely important in preserving portfolio values. There are no guarantees how long it will take to recover from a market decline. And, this is not a good time to be poor.

We would be the first to admit that there is no perfect investment approach. Investing always carries risk. But there is also the risk of inflation and of not having the financial ability to retire when you want to. Our job is to balance those risks; to invest with a strategy designed to limit losses, but still participate in the market when we see opportunities. We welcome the opportunity to review our approach to investing with you at any time.

## Learn to Detect On-Site ATM Scams

Any time you withdraw money or enter a transaction on an Automated Teller Machine (ATM), you need to be alert to scams designed to steal your account and pin numbers. And, there's some pretty ingenious technology in place to do so.

The most common means of capturing data from the magnetic stripe on the card is a device fastened in close proximity or over the top of an ATM's factory-installed card reader. The device reads and stores the data on the magnetic stripe. Capturing a pin number is often by means of micro cameras or imaging devices attached to the ATM. Touch sensitive plates have also been placed over the keyboard to record keystrokes. Before using an ATM, check for any unusual or non-standard features. Most ATM's are single surface construction. They don't have add on panels or overlays. Look for signs of tampering; pay particular attention to the touch and action points. Anything that looks like a camera should not be considered just security monitoring. If you have any concerns about an ATM, don't use it. It's much easier to find another ATM than it is to fight fraudulent charges to your account.



## 1st Quarter Newsletter

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