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# CAPITAL INVESTMENT MANAGEMENT

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*Registered Investment Advisor*

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## First Quarter Newsletter

**April 1, 2007**

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## The Bright Side of Volatility

*“The longer a condition exists, the more people expect it to continue.”*

Which would you consider the healthier financial market environment? One in which stock values steadily increase over time, or a market subject to fits and starts with periods of price increases interrupted by corrections?

The first example may be easier to live with, but the second — the market filled with greater volatility — may be the healthier environment for investors.

Stability has one major disadvantage. The longer a condition exists, the more people expect it to continue.

Complacency is an investor’s greatest enemy. When we start thinking we know what the future will bring, it inevitably leads to riskier behavior, which can drive values higher over the short term, but historically, results in a more severe correction.

The housing market is a prime example. By 2002, housing prices had been on the rise for more than a decade and were posting double digit returns in many U.S. cities. Burned by the financial markets, individuals turned to housing as a “can’t lose” investment.

Since everyone knew home values were only going to increase, creative mortgage products — from no or minimal down payments and interest-only loans to adjustable-rate mortgages carrying starter rates as low as 1% — became common.

Even individuals who might not consider themselves housing speculators took part in the housing boom through refinancing and withdrawing equity from their homes. Financial instability, points out Nobel Laureate economist Hyman Minsky, is created by mounting indebtedness building up through time. Complacency equals riskier behavior.

Today, this build up in housing-based debt and the use of speculative financing tools are blamed for a large part of the explosion in foreclosures. The housing markets hardest hit are those that experienced the greatest gains.

The dangers of complacency are even greater in the financial markets. At the start of 2000, internet stocks were the place to be. These were the investments with the greatest long term potential, the stocks that were changing the world. Hindsight tells us otherwise.

What history proves again and again is that avalanches happen. Stress tends to build up in markets as investors become complacent and take on more risk. Values can continue upward longer than might seem rational in another time. And ultimately, markets correct.

Much like a volcano, small shocks over time can lower pressure along growing fault lines, moderating or postponing more severe reactions. But perhaps their

greatest value is that of a reality check. They are a reminder that bad markets can happen to good people and that risk is always an element of investing.

Our job as advisers is to help clients avoid complacency, to remind them of the risks and to manage their assets with the recognition that we don’t know what tomorrow will bring. Investment strategies need to be flexible, to look for opportunities in trends and cycles, but to also recognize that there has to be a plan in place to help limit losses should the markets turn against us. Complacency may be a lot easier to live with, but paranoia has its place in any investment approach.

### Famous Market Bubbles

1634 -1637 – Tulipomania

1711 – 1720 – South Sea Bubble

1717-1721 – Mississippi Scheme

1840s – Railway Mania

1920s – U.S. Roaring Twenties Market

1970s – Nifty Fifties

1980s – Biotech stocks

Late 1980s – Japanese stocks

1987 – Taiwanese stocks

Late 1990s – Internet Stocks

## The Bright Side of Volatility (con't.)

*"Can It Happen Again?" by Hyman Minsky*

The following stages of a market bubble and collapse are from "Can It Happen Again?" written in 1982 by Nobel Laureate Hyman Minsky.

Stage 1: The shock wave -A disturbance alters the current economic status quo, putting the spotlight on an asset class.

Stage 2: Acceleration – Fuel gets the fire going, starting the boom.

Stage 3: Euphoria -The latecomers rush in while the insiders start stepping out.

Stage 4: Financial distress -Fear sets in, and the latecomers begin to sell.

Stage 5: The market reverses, and the boom turns into a bust -Prices begin to drop, money tightens up and losses start to accelerate.

Stage 6: Panic – The boom is officially a bust. Professional investors start to get interested again.

Stage 7: The White Knight rides in – This occurs when the bust really explodes and the government steps in. While well-intended, the results of the knight's actions are not always the best solution to the problem.

## The Bright Side of Volatility

*"The NASDAQ Composite is A Market-value weighted index."*



The Nasdaq Composite is a market-value weighted index of all common stocks listed on Nasdaq Exchange. Investors cannot trade an index directly. The above graphic does not take into account trading costs or fees that would be incurred to invest in a representative basket of stocks. Past performance is not indicative of future returns.

The Nasdaq Composite's tremendous build-up in 1999 has become a case study for why market bubbles happen and how much people want to believe that the recent past will continue on indefinitely. There was no shortage of forecasts at the start of 2000 that proclaimed this a new era for the markets, that the old rules no longer applied.

## A New File For Estate Planning

*"What happens with login accounts should you die or become mentally incapacitated."*

Do you access account balances and make transactions on line? Perhaps you have a positive balance in your PayPal account or have set up automatic deposit or payment plans online for subscriptions and other on-going expenses. You probably have your own login and password to access personal files on your personal computer.

What you may not have considered is what happens with login accounts should you die or become mentally incapacitated. Will your login information and password be lost with you? Will your survivors be able to access information and documents kept on hard drives or in on-line accounts? Will they be able to stop auto-shipments

or cancel on-line subscriptions? Will your executor need a court order to access the information, provided the individual even knows where your accounts are? Keeping track of assets in the electronic age means adding another file to your estate planning process. A file that provides the information needed to access password protected sites, accounts and information.

- Each member of your household should keep a spreadsheet with Institution Name, Website, Account Number, User Name, Password for any financially related sites as well as personal login information for your computers.

- This spreadsheet must be updated **WHENEVER** a change is made to an account, including new passwords, or accounts are

added.

- Save the spreadsheet to a removable media format (CD, DVD-R, USB Flash-Drive, etc).

- Place the removable media format in a safe location that your spouse, power of attorney, key adult child(ren) and attorney are aware of (safe deposit box, fireproof vault, drawer in the house where the important stuff is).

- If putting all this in a safe place and telling key people of it concerns you because those people might have access to your accounts before something happens to you, you need to rethink the key people. This record-keeping should apply both to personal and business accounts.

## Has Your Life Changed?

*"Please give the office a call and let's schedule a meeting."*

Just as markets change, so do the lives of our clients. Which is why we try to ask you at least once a year if there have been changes in your life that might necessitate a change in how your assets are invested. This might be good news, such as a new family member, a new job, a move or even an inheritance. Or it may be an event from the other side of life, such as a family illness or death, the loss of a job, or losses from investments outside our control.

Sometimes, clients don't realize that these changes may also impact the investments we manage. If we haven't

had a chance to catch up on changes in your life, please give the office a call and let's schedule a meeting. This can be an excellent time to review progress in your account and where you would like to be in the next few years.

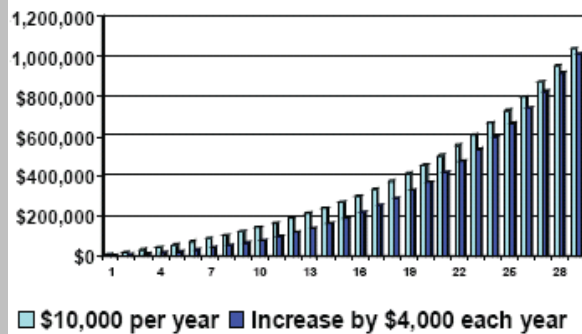
Naturally, we are always interested in receiving additional funds to manage and welcome any referrals you might have of family members, friends or associates who might benefit from our services. Take a moment now to call and let's talk!

**Call us at 303-221-1000.**

## What Does It Take to Have \$1 Million in Investments?

*"...\$1 million in investments is attainable for individuals with less financial resources but the dedication to stick with a plan..."*

### Reaching \$1 Million in 30 Years



To have \$1 million by retirement, all an individual needs to do is to invest \$10,000 a year for 30 years and have it earn at least 8% compounded annually. That's assuming no fees or taxes erode your earnings each year.

Can't quite manage \$10,000 annually? Consider investing \$4,000 for the first five years and then increasing your investment to \$8,000 annually the next five years, \$12,000

for five years after that so on, reaching \$24,000 annually by year 26. By year 30 you will have invested \$420,000 compared to \$300,000 for the individual investing \$10,000 per year, but your account balances will be relatively close.

Earn more or less and naturally your final result is going to vary. But what this illustration shows is that \$1 million in investments is attainable for individuals with less financial resources but the dedication to stick with a plan of steady contributions.

Even if you don't have a 30-year time frame, steady investing combined with a carefully considered investment approach can build a substantial portfolio faster than you might think.

*Remember this is a hypothetical example and there can be no guarantee that your account will achieve an 8% return each year. All investments have risk and can lose as well as make money. Past performance should not be considered indicative of future returns.*

## Faulty Logic

*"Lotteries are voluntary taxes, not a means of achieving financial security."*

**Twenty percent** of adults surveyed said a lottery would be the most practical strategy for accumulating several hundred thousand dollars, according to a recent survey of about 1,000 Americans by Opinion Research Corporation.

The likelihood of this "practical" strategy failing is 99.99997394%. Buy tickets for 50 successive lotteries and you are 99.998697% likely to lose. That fails to meet even the most liberal definitions of "practical."

Lotteries are voluntary taxes, not a means of achieving financial security. Those who do win often find the money brings with it a host of woes, first and foremost of which is that others don't believe the individual(s) deserved to win, much less deserve to keep the money when others less fortunate could use it.

The real key to accumulating several hundred thousand dollars starts with investing funds you've chosen not to spend.

## 4th Quarter Market Update

*"Many Models have maintained their positions though the volatility of the first quarter..."*

The market performance of the opening quarter of 2007 offers compelling evidence that the US economy and domestic markets are becoming increasingly more dependent on global stability and foreign policy issues. Until the decline last month, the US markets experienced a nicely channeled upward trend from August of 2006 to February 2007. Stable and steadily upward ascending trends such as these allow the models to hold positions long after their minimum holding periods expire. We saw Real Estate positions blossom in the latter half of last year, to lead the 2006 market with stable and robust gains. The next best performing categories were the more volatile international markets and growth oriented positions such as Asia, Russia, Latin America and other Emerging Market territories. The six and a half month climb was reminiscent of the nine month ascent from April of 2003 through the end of December 2003. However, all trends must come to an end, and when they do, new dominant performers tend to emerge, often times from previously overlooked sectors. It may be too early to predict which sectors will become the new leaders. Time will tell if the DJIA's recent 732 point decline in 12 market days of the first quarter was just a normal market correction from the previous six month upward trend or an indication of more serious economic distress that might lead to further market declines. In either case, the models are constantly evaluating the market offering insight into the sectors or investment positions that may be poised to become the leaders of the next trend.

Employing advanced technology to aid us in the investment analysis process is paramount in evaluating such wide changing and volatile market moves. Portfolios are often comprised of several models that work in concert with each other to offer healthy levels of diversification. Each model acts independently of the other models and serves as a powerful check and balance structure to help long-term investors navigate volatile markets. While some models may have a minimum holding period that will span the gap of an ordinary market correction, other models outside their minimum holding periods might interpret the downdraft as the next trend and reallocate to new positions of strength. Evidence of such emerging sector strengths are the bond trades we have seen in the past quarter. All in all, we see the recent market activity as a healthy and normal cycle that most markets experience from time to time. In fact, one could claim that the recent volatility over the last month has been overdue. Before the one day 3.5% fall in the S&P 500 on February 27<sup>th</sup>, the S&P 500 had experienced 949 trading days (no weekends or holidays included)

without as much as a 2% decline. It was the longest period of time without such a decline since 1950.\* In the last 20 years, 1987 through early 2007, there have been a total of 22 occasions in which the S&P 500 has declined by 3.5% or more in a single trading day. Of those 22 instances of single day sell offs, 16 resulted in positive gains over the next full year, five resulted in negative returns, and one was a break-even occurrence.\*\*

What is the historical significance of these references? Past performance is not indicative of future results, however, it is important to learn from past market cycles to acknowledge the different possible outcomes. While this data might lead one to believe that the market experiences these interruptions from time to time and as such, we should accept this volatility as part in parcel of the normal course of equity investing, we do not believe that to be enough data upon which to base current allocations. As previously stated, if you were waiting for a single day sell off in the last 4 years as a potential indicator of when to make changes to your portfolio, you would have been waiting a long time. Over that period, you would have missed out on some nice returns, as opportunities to invest in positions of strength usually exist in every market. Our opinion is that we should employ technology to aid us in the review of all market activity. The technology needs to be able to identify the minor daily market adjustments as well as large meaningful market corrections and/or extended trends. Whether a 400+ point decline occurs on a single day or over an extended 2 or 3 month period, the move still requires analysis. To have the ability to display subtle market moves over 60 to 150 days, in addition to large market corrections that occur in shorter time frames, enables us to identify market data that creates a larger scope than just a day, week or month long trend. Our process is in search of longer term upward or downward trends, but does not ignore the shorter trends or abrupt market moves that often create anxiety when they occur. Many models have maintained their positions through the volatility of the first quarter, which had previously experienced positive movement from the fourth quarter of 2006 and early February 2007. Other models chose to capture profits and have opted for defensive positions such as Zero Coupon Bonds and Utilities. The major market indexes experienced volatile movement in the first quarter of 2007. The Dow Jones Industrials posted a flat return of -0.87%. The Standard & Poor's 500 Total Return (Inclusive of Dividends) returned 0.64% while the NASDAQ ended with 0.26% and the Lehman Aggregate Bond finished with 1.35% for the quarter.\*\*\* With regard to our 4<sup>th</sup> quarter news letter of 2006, we have been requested to track the IBD Index that was discussed in that letter and it

performed admirably when compared to the other indexes with a first quarter return of 2.86%.

Looking forward to the rest of 2007, the Fed appears reluctant to offer any firm guidance relative to the state of the economy. Some comments in the first quarter would indicate that it is more likely to cut interest rates than increase them by the end of the year; however, it has not yet abandoned its bias toward inflation management. If the US economy continues to slow at a gradual rate, we may see a reduction in US Consumer spending. Concern over US consumption rates relates to the recently reported drop in US housing prices. This drop has created fears both domestically and abroad that the US consumers will feel less wealthy and may therefore rein in spending. Consumer spending makes up about two-thirds of U.S. economic activity. However, other bright spots exist, including the current state of the labor market, low unemployment levels and the current position of the political cycle. As Democrats and Republicans gear up for the 2008 election, Republican Leaders will likely do all they can to create a positive economic environment.

We believe careful analysis of prices/trend changes, may offer us some insight into the market(s) prognosis for future prices. It goes without saying that any system, is not infallible and does not assure positive results. When the markets are uncertain about future prices they tend to stagnate or even decline. It is important to realize that modeling is not intended to time the markets or trade short-term micro cycles. Rather, this strategy attempts to identify changes in market direction, industry and sector price behavior in an effort to participate in those longer term trends.

*No investment strategy can guarantee profits or protection from losses as securities are subject to market volatility. The analysis, ratings and/or recommendations made by the Scofield computer models do not provide, imply, or otherwise constitute a guarantee of performance. No guarantee is offered by Scofield and Company regarding the accuracy, market predictive powers, suitability or profitability (either expressed or implied) of any of the information provided.*

*Indices are unmanaged and cannot be directly invested into. Actual investment performance of any trading strategy may frequently be materially different than the pursued results.*

## CIMCO'S INSIDE STORY

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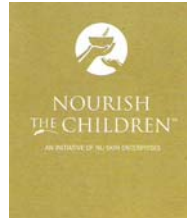
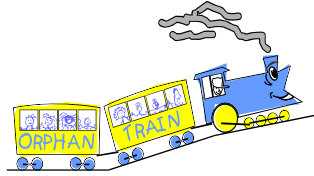
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