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CAPITAL INVESTMENT MANAGEMENT

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Is Performance the Reason to Go Passive?

“Does this mean these strategies are unsuccessful? No. It comes back to performance.”

There's been a recent upsurge in articles supporting passive investing – the strategy of investing in index funds and exchange traded funds designed to mirror indexes and holding on for the long term. But before you decide passive is the answer, take a moment to walk through the realities of index investing and then answer whether that's really a style you can stick with for the long term.

There are two primary arguments in favor of passive investing:

1. Low costs
2. The difficulty of active investment approaches in consistently beating the market.

Index investing by its very nature should be lower cost. There's no need for highly paid analysts and trading costs are typically lower, reducing drag on the fund's return. The lower the costs, the closer the fund should be able to match its index in performance. But do you really want to match the performance of the index?

Because news coverage of the financial markets typically deals with the very short-term of a day or a week, it's easy to lose sight of how much bear markets impact investors.

A buy-and-hold position in the S&P 500 or the Nasdaq Composite index looks relatively calm when just the last four years are considered. Go back three more years and the picture is dramatically different.

In 2000-2002, the S&P 500

fell more than -45%, while the Nasdaq Composite was off by -74%. Seven years later the S&P 500 is finally approaching its prior high. Many analysts believe we will not see the Nasdaq retest its earlier highs for at least another decade. Would you have been better off in a safe utilities sector? Not really, the Dow Jones Utilities index lost -50% between late 2000 and October of 2002.¹

What does that mean to an investor? Well, suppose you had \$500,000 invested in a S&P 500 index in early 2000. Over the next two years, you would watch your retirement savings whittled to \$270,000. A loss of \$230,000. A \$500,000 investment in the Nasdaq would have lost \$370,000. How long will it take you to save a comparable amount? Would there have become a point at which the pain was too great, at which you sold out your position, rather than see it continue to dwindle?

Selling a position brings up the question, when do you re-enter the market? Do you wait until the market has gone up sufficiently to make you more conscious of the gains you are missing than the loss you suffered? By then, you may have missed a major portion of the current up move.

Study after study has shown that individual investors dramatically under-perform the indices because they buy and sell at the wrong time.¹ Rather than sell early in a decline, they wait until they can't bear another down day. And then they are hesitant to re-enter the market. They

become “accidental active investors” without a real strategy that attempts to quantify and manage risk.

The catch in the second statement - *The difficulty of active investment approaches in consistently beating the market* - is the word “consistently.” Every year there are portfolio managers who clearly excel. Over time, however, their results tend to average out. With the additional burden of management fees, research and trading costs, many active strategies will lag the major market indexes at one time or another in their performance history. Does this mean these strategies are unsuccessful? No. It comes back to performance.

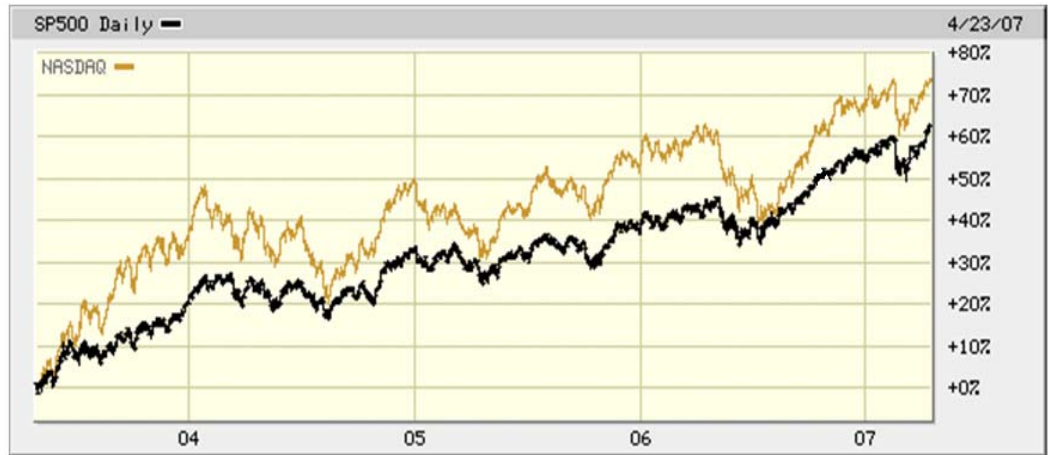
While there can be no guarantee that active management will outperform passive management approaches on a risk-adjusted basis, and all investments face the prospect of loss as well as gain, good active management recognizes that markets are volatile and looks for ways to capitalize on opportunities while minimizing losses. By acknowledging risk and looking for ways to reduce its impact on the portfolio, there is naturally a drag on performance. Rather than racing full out around the corners, a good manager brakes.

When active management reduces the vulnerability of a portfolio to bear markets, it preserves capital in down markets and helps keep investors committed for the long term.

(con't)

Growth of the S&P 500 and Nasdaq Composite Indexes Four years ending June 30, 2007

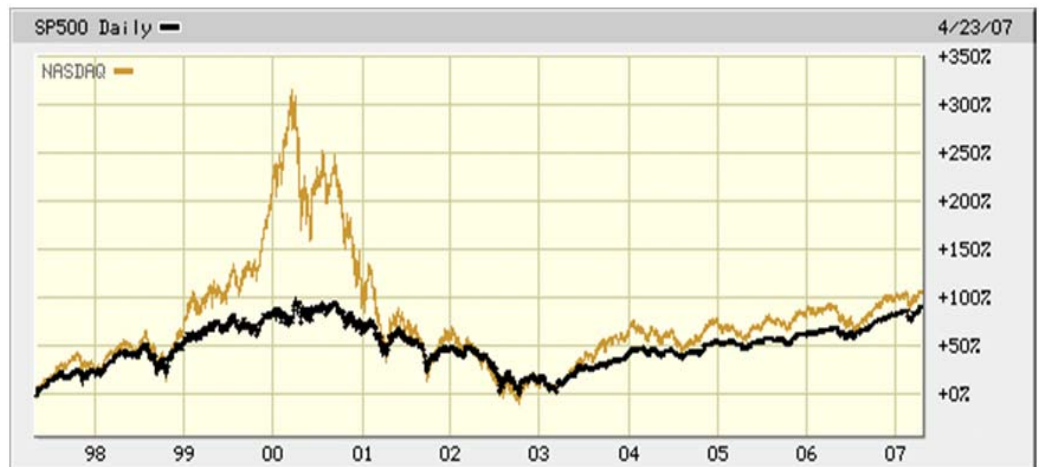
"A buy-and-hold position in the S&P 500 or the Nasdaq Composite index looks relatively calm when just the last four years are considered."



Data: Yahoo Finance. Past performance is not indicative of future be invested in directly. Trading and management costs that would be involved in creating a portfolio to mirror the composition of the indexes are not reflected in the graphics.

Growth of the S&P 500 and Nasdaq Composite Indexes Ten years ending June 30, 2007

"Go back three more years and the picture is dramatically different."



Data: Yahoo Finance. Past performance is not indicative of future returns. The S&P 500 and Nasdaq Composite are indexes and cannot be invested in directly. Trading and management costs that would be involved in creating a portfolio to mirror the composition of the indexes are not reflected in the graphics.

When Ownership Form Matters

“Will your spouse have immediate access to your assets or will those assets first need to pass through probate?”

While it's always a pleasure to see the asset side of your balance sheet increase, but with accumulation also comes the question of ownership. How you title your assets will make a difference should you die.

- Will your spouse have immediate access to your assets or will those assets first need to pass through probate?
- Will your assets incur estate taxes?
- Which assets will be covered by your will and which will pass directly to your beneficiaries?
- How can you assure that your assets will be distributed as you desire should your will be disputed?
- Can you move some assets out of your ownership now to reduce estate taxes, yet still control the assets?
- How can probate and administrative costs for your estate be reduced?
- Will the value of your assets be influenced by ownership agreements, such as partnership buyout provisions?
- Can you prevent your heirs from losing their inheritance through poor decisions?
- How can assets such as a long-time family property be kept family property be kept in the family?

The answers to these questions are all impacted by how your assets are held. The

following are the most common forms of ownership. As you set up and modify your accounts, make certain you talk with a tax or estate adviser to assure that you understand the ramifications of different ownership forms and their impact on your estate.

Individual Ownership: You are the sole owner of the asset. In the event of your death, the asset passes on to your estate to be distributed according to your will. Under current tax law, your heirs will be liable for estate taxes on the asset but they will pay capital gains taxes only on appreciation while they hold the asset. This avoids the prospect of double taxation.

Individual Ownership with a Designated Beneficiary: An asset such as a retirement account is held in individual ownership with designated beneficiary(ies). Upon the account holder's death, the asset passes directly to the beneficiary(ies). While the value of the account will be included in the estate for the calculation of estate taxes, ownership is not impacted by an existing will or probate. Transfer of ownership can be as simple as presenting a death certificate.

Another form of designated beneficiary is a "Transfer on Death" designation, which can be used on non-retirement accounts, such as a brokerage account.

Tenants in Common: This is ownership in an asset by two or more persons at the same time, not necessarily with equal interests or rights. On an owner's death, the individual's interest passes to his/her heirs named in the will

who then become the new tenants in common with the surviving tenants in common.

Joint Tenancy: Each joint owner has an undivided right to possess the whole property and equal ownership interest. When one joint tenant dies, his/her interest automatically becomes the property of the surviving joint tenant(s). This is a common form of ownership between husband and wife.

Trust: Assets are transferred to one or more recipients, called trustees, who hold legal title to the assets and manage the assets for the benefit of the owner or other named beneficiaries. Living trusts are set up during the grantor's lifetime and may be either revocable (changeable) or irrevocable. Living trust assets do not need to be probated and are not subject to public disclosure. A testamentary trust is set up in a will and becomes effective at death. It is subject to probate fees and estate taxes.

Partnership: This is an association of two or more persons who have an established partnership agreement to conduct, as co-owners, a business for profit. Partnership agreements typically establish the rules for buying out a partner's interest in the business in the event of a dispute within the partnership, death or the desire of one partner to move on.

The preceding is not intended as legal or tax advice, but rather an introduction into different ownership forms that can be used by an individual. Please consult with your financial, tax or legal adviser if you have any questions about the best form of ownership for your accounts.

Buy a New Home or Invest Your Money?

"Looking forward to 2007, it appears as though many of the menacing "what ifs" have attained at least some level of clarity."

For many Americans, their home is their biggest single asset and too often an asset they consider a major element of their retirement fund. But even with the last decade of double-digit appreciation in many real estate markets, a home has a number of drawbacks as an investment.

- (1) A home costs considerably more than most people realize, diluting its value as an investment.

If you financed your home with a traditional 30-year loan, you will probably make interest payments roughly equal to or greater than the original purchase price of the home. Even after deducting interest costs from taxes, you've still spent a substantial amount to finance the purchase of your home.

The costs don't end there. Every year, you pay homeowners' insurance, property taxes, maintenance, utilities and often homeowners' association dues. Add a few major repairs, such as a new roof, and renovations to maintain the value of your property and the cumulative expense is more than you might realize.

Your real profit isn't the difference between what you purchased the home for and its current value. To reach that value you need to add in the carrying costs you incurred over the years.

Most homeowners will argue at this point that they would have incurred costs to rent a place to live if they hadn't owned the home. But until

you look at the actual costs of homeownership, you can't really judge how much owning a home actually costs. Many homeowners also buy as much home as they can qualify for regardless of whether or not they need the space, justifying the additional expense as an investment.

- (2) Selling your home to cash out on your equity still leaves you in need of shelter.

While you may be able to scale back your home style sufficiently to pocket some of the equity you've accumulated in your home, many retirees find their dream retirement home is not the bargain they anticipated.

- (3) Double-digit real estate appreciation is not the norm.

The U.S. historical average annual housing appreciation is 5-6%. At these levels, it will take more than 12 years for a home to double in value and appreciation will not necessarily be a steady upward progression.

The last big run up in housing values was the period following World War II when the GI bill made financing a house affordable for the returning soldiers. That surge was followed by 20 years during which the average home price went essentially nowhere.* The housing booms of the 1970s and 1980s were followed by returns to levels consistent with appreciation rates following the 1950s.

As the chart below shows, following rapid gains in the 1970s, inflation-adjusted housing prices went sideways for 15 years in most of the country.

- (4) When your primary retirement asset is your home, you are not diversified.

Proper diversification has one very big objective and that is to insure that if something goes wrong with one aspect of your portfolio you have other assets to keep you from financial ruin. A home can be a very vulnerable asset, even with homeowner's insurance. A careful read of your homeowner's policy will turn up a number of circumstances in which the insurance company is exempted from coverage.

- A basic homeowner's policy doesn't cover flood damage. You need a special policy for flood insurance backed by the federal government, with cooperation from local communities and private insurance companies.
- Most homeowners insurance policies do *not* cover damage from earthquake, land tremors, landslide, mudflow or other earth movement unless through an additional endorsement at an additional cost.
- Insurance policies often do not cover hurricane and other windstorm damages. Supplemental coverage varies by state, and sometimes by county.
- Deliberate damage to the home caused by an owner may not be covered.
- Wear and tear from any circumstance is generally *not* covered.

Buy a New Home or Invest Your Money? (con't)

"Looking forward to 2007, it appears as though many of the menacing "what ifs" have attained at least some level of clarity."

Even if damage to your home is covered, circumstances may delay payment and the settlement may not fully cover the cost of replacing your home. For example, if repairs to your home must meet stricter building standards than its original construction, your insurance policy may not be sufficient.

If you want to buy a more expensive home, do so because you want to live in the home. If you want to build retirement assets, set aside funds and invest them where you understand the carrying costs of the investment, its potential and the risks that come with the investment.

As always, you have to remember that past performance is not indicative of future returns and that all investing carries risk. But the greatest risk is failing to invest at all.

If you are looking for better ways to finance your retirement, give me a call and let's talk.

- A History of Home Values, an inflation adjusted index of American housing prices going back to 1890, Irrational

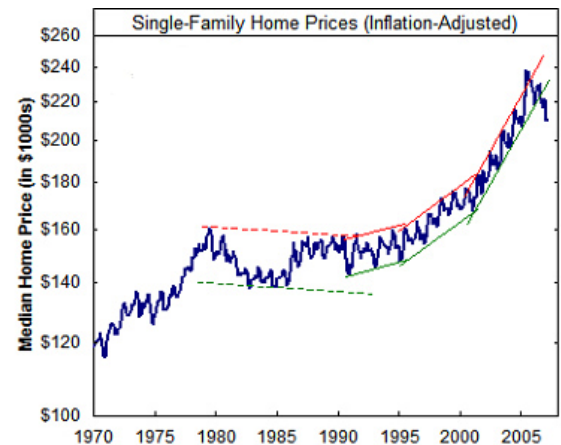


Chart courtesy of Chart of the Day. Following rapid gains in the 1970s, inflation-adjusted housing prices went sideways for 15 years in most of the country.

2nd Quarter Market Update

"...one significant difference from last quarter is that oil prices have dropped significantly from their highs..."

The hopes that the Federal Reserve Board would discontinue raising rates was realized in the third quarter and thus brought an end to the two and a half year, 17 consecutive rate hikes that started June of 2004. Since that time we have watched the Fed funds interest rate climb from 1% up to 5.25%. The market celebrated with an upward movement of 500+ points on the Dow Index since the end of the second quarter. However, the initial indication that a neutral interest rate policy would provide a stable economic environment for equity securities and bonds alike has been overshadowed by serious declines in the national housing market.

Also, the Federal Reserve has indicated that they believe the previous interest rate increases are

beginning to take effect, but they have admitted that they do not know how many of the 17 increases have been priced into the economic slow down. Often times when incremental movements are used over such a long timeframe it's hard to tell which rate increase was enough to produce the desired effect without taking the process too far. It's like turning on the faucet to wash your hands; usually you have to adjust the knob back and forth a couple times before you attain your desired water temperature. The same holds true of the economy when dealing with rate increases and decreases and since we have incrementally turn the knob to a cooling off position, it may at some point in the next 6 to 12

months need to be turned back the other way.

As more and more numbers begin to be relayed about the housing market, which employs a vast amount of individuals across the nation. We will see the effects the housing market's previous contribution to the general health of the US economy. Not to mention the numerous American homeowners that opted for the 1, 3 and 5 year Adjustable Rate Mortgages (ARMs) that will be gasping at their new monthly mortgage rates. Most of these individuals will be able to service their debt load by making adjustments in lifestyle or discretionary spending, but when a mortgage payment jumps by \$200 to \$400

CIMCO'S INSIDE STORY

SPRING CLIENT EVENT

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