

# SMALL-CAP VALUE COMMENTARY LETTER FIRST QUARTER 2005

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## Portfolio Performance

The equity markets began 2005 with a rather uninspiring quarter. All U.S. equity indices ended the quarter in the red, with growth trailing value across all market capitalizations. Small-cap stocks were unable to continue their fourth quarter momentum, as reflected by negative performance in both the Russell 2000 Value® Index, down 3.98 percent, and the Russell 2000® Index, down 5.34 percent. Large-cap stocks performed somewhat better than small-caps, as the S&P 500 Index was down 2.59 percent.

From a positive perspective, energy stocks led the small-cap market this quarter as the price of oil continued to rise. In fact, utilities and consumer staples were the only other sectors that produced positive returns. The consumer discretionary and materials and processing sectors both were negative for the quarter, yet lost less than the small-cap indices.

In the financial services sector, the continuing increases in short-term interest rates have begun to detrimentally impact financial services stocks, as they were one of the greatest contributors to negative performance in the indices. Other sectors that significantly contributed to poor index returns this quarter included technology and health care.

ICM's Small-Cap Value portfolios performed considerably better than the indices for various reasons. As we have discussed in previous commentaries, we remain true to our decision to underweight financial services because of our belief that rising interest rates would be materially unfavorable to stocks in this sector. Furthermore, small-capitalization financials are not compelling investments, due to their disadvantages of scale versus their larger brethren, and the likelihood that they have seen peaks in valuation and returns on equity. We were finally rewarded for these convictions, as the Russell 2000 Financial Services sector of the index declined by almost 8.3 percent. Our enthusiasm remains restrained for this sector and we think it unwise to materially increase our exposure in the immediate future. In the meantime, we prefer to confine any new portfolio additions to companies in this sector that are turnarounds, run counter-cyclical to interest rates, or are not inherently interest rate-sensitive, which is a small subset of the entire financial services sector.

Some of the best performing stocks emerged from the health care sector, as two companies subject to takeover offers rewarded our stock selection. We also had some winning consumer discretionary sector stocks that benefited overall performance. Energy stocks also made money for your portfolio in an absolute sense.

From quarter to quarter, different style factors dominate others in stock performance. This quarter we noted a trend of superior performance from stocks with the lowest price-to-sales ratios, and we were positioned to benefit from this development.



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## **Market Environment**

This past quarter, the Federal Reserve continued to raise the target for its key overnight federal funds rate, and the bond market experienced increased interest rates across the entire U.S. Treasury yield curve. As long as the Fed continues with these measured rate increases, the financial services sector will naturally be affected.

Oil prices continued to rise this past quarter and remain at elevated levels. We expect prices to remain high and do not anticipate a significant decline any time soon. Oil prices now act as a tax on other areas of consumption: a dollar spent on oil is not spent on anything else. We therefore believe that persistently high oil prices will persist being a significant drag on the U.S. economy as the year progresses.

A key driver of our economy the past few years has been the rise in real estate prices. Low interest rates and easy credit terms such as zero down payments, sub-prime loans at attractive entry rates, and interest-only payments have helped fuel the growth in home prices. Mortgage refinancing has put money into consumers' bank accounts; these funds have supported enhanced consumption. Looking ahead, rising interest rates will probably impact the housing market, as borrowers struggle to keep up with higher payments. We may then observe the peaking of home price appreciation and quite possibly the bursting of localized "bubbles" in this asset class. The severity of this "bubble bursting" would most likely vary by region, but we believe the overall effect on the U.S. consumer and the economy will be decidedly negative.

At this stage in the economic cycle, we would expect earnings growth to decelerate from the levels of the last couple of years. Soaring oil prices and a rise in interest rates will be a drain on consumer demand, and profit margins are already at historically high levels. In addition, earnings as reported under Generally Accepted Accounting Principles (GAAP) will require that stock options granted to employees be expensed—yet another headwind to earnings growth.

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## **Looking Forward**

Given all of these factors, stock price appreciation and overall earnings growth should be restrained for the remainder of 2005. Since the summer months are historically a seasonally poorer period of performance, the small-cap market may well struggle through the end of summer. However, we remain disciplined in our style despite this subdued environment, and this potentially labored market should provide the kind of buying opportunities consistent with our strategy, which focuses on identifying stocks that are out-of-favor for reasons we believe are transitory. Absent a catalyst, it will be a "stock picker's market" and we remain focused on finding ideas that will continue to benefit your portfolio.

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