

## **SMALL-CAP VALUE COMMENTARY LETTER SECOND QUARTER 2007**

---

### **ECONOMIC OVERVIEW**

The second quarter of 2007 picked up where the first quarter left off, continuing its upward climb, while shrugging off the concerns that led to a pullback in stock prices in the middle of the prior quarter. We are pleased with the gains achieved this quarter, in light of the continuing risks hovering on the horizon. Two risks that stand out are the impending recognition of sizable losses sustained, due to imprudent underwriting in the mortgage market, and the continued weak showing of portions of the U.S. economy. Despite this uneven economic environment, we are happy to report that it was a rewarding quarter for our clients.

One of the factors driving the market this past quarter was the high level of mergers and buyouts. The continuing phenomenon of large pools of private equity capital, combined with readily available cheap debt, is the fuel propelling this extraordinary activity. We benefited from a number of these transactions and are gratified the takeout premiums we received validated our thesis of buying companies that are trading below their intrinsic value. Yet, we are aware the flow of easy money supporting the buyout mania can dry up rather quickly. As detailed below, our investment strategy is much more disciplined than just “looking for the next company to be taken over”.

There are already signs that the environment of easy credit is moving toward tightening. There is trouble brewing in the lower quality tranches of the bond market. Some exotic mortgage products written for the benefit of sub-prime borrowers are showing signs of stress. We have seen evidence that bonds created to represent these mortgages are now being written to reflect the underlying deterioration of those mortgages. As a result, significant losses will be recognized. What is unknown presently is how wide the contagion will spread. We expect credit availability to suffer and the cost of credit to increase, at a time when the current economic expansion appears to be unsteady.

During the first quarter of 2007, the U.S. economy grew at a meager real rate of 0.7% annually. This was on the heels of the last three quarters of 2006, when growth was at a real rate of about 2.25% to 2.5%. Most forecasts we have seen expect growth to accelerate in the second quarter; however, we do not expect the Federal Reserve to help matters by easing interest rates soon. The Fed remains focused on forestalling inflation, which they still judge as a greater threat than

recession at this time. The primary risk we see is that the Fed might maintain a tight money policy for too long, and in turn choke the economy into a recession.

Our monetary leaders however, have their work cut out for them. The residential housing market has clearly embarked on a down-cycle, the length and duration of which remain unknown. We believe this cycle will be protracted, and will produce significant headwinds against overall economic growth. Even if the Federal Reserve eases short term rates, this cycle must run its course. The housing market went to an extreme, with prices appreciating at an unsustainable rate, affordability hitting a trough, and mortgage underwriting becoming too lax. Now, inventories of unsold properties are bloated and lenders are reacting to pressure to reduce risky lending on homes, which will exacerbate the downturn.

The rising tide of home prices, since the dawn of the new millennium, was itself a source of economic growth, as consumers used their home equity to supplement personal consumption expenditures. Earlier this year, the Federal Reserve released a study, authored by Alan Greenspan (remember him?), which concluded that consumers' extraction of equity from their homes from 2001 to 2005 financed close to 3 percent of annual personal consumption expenditures, as broadly measured. Now that home values are receding in much of the country, consumers' ability to use their home as an ATM machine can be expected to be impaired compared to the standard set earlier this decade. If this so-called wealth effect goes away or diminishes, it will, in turn, produce a drag on consumption spending. Like the "Energizer" bunny, this economy keeps going and going, but we wonder if the batteries are starting to run low.

Having stated the risks this economy faces, we remain positive about being able to find opportunities and provide good performance. There are still some bright points; for example, monetary policy is not (yet) restrictive, as the yield curve has turned positively sloped again. Stock market valuations seem reasonable, and corporate earnings are still growing. The economy probably grew faster in the second quarter than it had in the first. Also, we continue to experience historically low unemployment rates in this country, and, as we have stated before, the consumer side of the ledger represents about 70% of GDP. All in all, the sky is not falling; we remain cautiously optimistic and believe the U.S. economy can muddle through what looks to be a mid-cycle slowdown.

In addition, the upcoming quarter contains the seasonal tax-selling period, when we traditionally have found many buying opportunities as other investors discard their tax losses and artificially depress prices, temporarily.



## **PORTFOLIO PERFORMANCE**

The second quarter of 2007 produced solid positive gains, even though we saw the market give back some of its gains after peaking in early June. In spite of the late quarter sell-off, we are pleased to report that the portfolios performed very well in the quarter.

We were cautiously optimistic about the portfolios' potential at the end of the first quarter, and the resulting success in the quarter can be traced to a number of factors. We benefited from several announced acquisitions of companies in the portfolios. Also, relative to the benchmark indices, our low weighting in financial services stocks contributed importantly to performance. That sector was one of only two within the Russell 2000 Value Index that had negative performance for the quarter, while our stock selections produced positive returns. We've said in prior quarters REIT stocks looked richly valued, and this quarter the market agreed. The universe of small banks also fared poorly this quarter. Here too, we are gratified our judgment was confirmed.

Our Small Cap Value strategy has been focused on individual companies that are undiscovered, under-researched, or have become oversold relative to their fundamentals, as ICM has not had undervalued sector opportunities to exploit for some time. In the past year, our selection process stressed owning companies with unique factors and lifecycle changes, which could drive demand and produce company earnings growth from achievement of their planned improvements. ICM also sought companies that derive a significant percentage of revenues from outside of the U.S. as a buffer against a potential American-based economic slowdown. Both of these initiatives are in tact and should continue to benefit portfolios.

## **INVESTMENT SELECTION PROCESS**

Investors always have choices of where to put their money, and we would like to make clear why we are still bullish on small value equities as an asset class. Generally speaking, there are three main asset classes investors participate in: Equities, Bonds, and Real Estate. Currently, bond yields are already low; and buyers of long dated bonds are implicitly saying they are willing to accept the historical real yield of two to three percent from bonds, plus an inflation risk premium of about the same amount. Adjusted for inflation, stocks have historically provided a greater return than bonds. Also, we think the odds of inflation exceeding the inflation risk premium are meaningful, presenting a capital loss potential to the bondholder. Conversely, if bond buyers are expecting a capital gain, they are implicitly betting that interest rates will decrease materially, from already low levels; an event which, to us, still seems unlikely. Bonds remain an acceptable investment for stability and predictable income, but they are unlikely to outperform stocks for the foreseeable future.



Real estate has been the hot asset class so far this decade; and, we believe the odds are, it will slow down in performance, if for no other reason than returns typically regress to a mean in any asset class. Valuations of income properties have hit historically high levels, with buildings selling at capitalization rates well below 5% in many cases. Given that the cost of debt is at least that much, and the cost of equity even more, a buyer at these levels will require very significant rent increases just to earn a decent risk adjusted rate of return. Alternatively, property buyers could, like bond buyers, assume even lower interest rates (and higher property values) in an effort to resell to the proverbial greater fool.

Equities, as a group, appear to be neither very cheap nor expensive, but are within the range of past valuations. We think they continue to provide opportunity for company specific gains and that well selected equities are the place to be for the next couple years.

Our strategy seeks to own stocks of companies that can fare better if such a slow growth environment continues to unfold. We see no compelling “single decision” investment strategy. We are looking for companies that offer some combination of the following features.

First, we seek companies that can drive sales on a unit growth basis due to their individual company and industry dynamics. It might be a company and industry selling into the sweet spot of a product line upgrade cycle. Another example would be a company selling into a market niche that is growing fast due to a change in consumer tastes or economic realities. Note that this is often easier to quantify for smaller companies than large ones, because we can isolate the decision points to a smaller number of variables.

We are also keyed on each company’s or industry’s pricing outlook and competitive framework. We have more than one company in the portfolios that, although they are smaller sized companies, are dominating their market niche and are gaining dominant market share, both organically and through acquisitions. Pricing often becomes more attractive when the number of competitors is whittled down over time.

Finally, we own numerous companies that derive a preponderance of their revenue from outside of the USA. The world is becoming steadily less dependent on the USA for growth than it was in the past, thus a slowdown in America does not necessarily imply an equivalent slowing in foreign economies. The International Monetary Fund’s current *World Economic Outlook* studies this question in great detail, and concludes that past episodes of synchronous economic recession were not the result of the rest of the world following the USA when we had a recession, but were caused by factors that affected many countries at the same time. It cites the

price shock of 1974-1975, and the bursting of the technology bubble in 2000 as two such examples. Further, if the U.S. slowdown remains moderate, the spillover effect to our trading partners will be considerably smaller than the direct effect inside the U.S. In other words, our economies are only *partially* correlated. Meanwhile, the developing worlds' economies are expected to grow faster than the United States, so foreign sales exposure can translate into faster sales growth.

These strategic principles do not preclude investment in domestic based, high confidence, turnaround opportunities. We own a number of turnaround companies; that is, companies with unique, compelling, specific factors that can produce earnings growth from achieving their planned turnaround improvements despite any offsetting drag from a slower growth economy.

Finally, we are looking for companies whose sales outlook is not linked to the rate of GDP growth. An example of that would be a late economic cycle company that is dependent on state and local government spending for its revenue stream. State and local budgets around the country are looking flush with surpluses, and we expect that surplus cash to be spent.

Overall, we remain in the middle of an economic cycle that is slowing, one which will either reaccelerate or dip into recession, with no compelling discounted sectors to buy. This environment calls for selective stock picking, and that is our focused, disciplined approach at ICM.

---

*We request that clients advise ICM in the event that there are any changes in their investment objectives, financial situation, or whether they wish to impose or modify restrictions on the management of their account. Please call ICM at 800.488.4075 or visit our Web site, [www.icmasset.com](http://www.icmasset.com), if you have any questions or need additional information.*

