

# SMALL-CAP VALUE COMMENTARY LETTER FOURTH QUARTER 2006

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## Economic Overview

Looking back at 2006, we see that the small-cap segment of the stock market again provided us with generous returns, marking the fourth year in a row of positive returns for investors. Yet, these returns were earned despite the risks we discussed in our letters over the past year. The double threats to the consumer reflected in elevated oil prices and a slowdown in home price appreciation were major features on the landscape this past year. The U.S. dollar weakened slightly versus the major world currencies, though not excessively. The war in Lebanon came and went, and the Iraq conflict continued.

While we might want to give ourselves a collective “pat on the back” for the profits reaped in 2006, we caution investors that 2007 presents similar potential challenges. Right now, a slowdown in the economy still appears to be unfolding, but the timing and magnitude of the deceleration remains unclear. The pertinent questions are: When will a slowing be clearly obvious to all? How much of a slowdown is probable? And, how long will it last? At present, there does not appear to be enough weakness to forecast a recession. Rather, we are experiencing a period that is a textbook example of the latter portion of an economic expansion. The Federal Reserve has withdrawn the stimulus it created back when a recession was apparent early in the decade. We now have to watch and see if this economy can grow at a reasonable rate on its own without the help of an expansionary monetary policy. The key then is how much the economy will slow.

Moving into the New Year, we describe ourselves as “cautiously invested.” Unless or until a more pronounced slowdown becomes apparent, we maintain a constructive attitude about being able to make money in the market this year. However, it makes sense to restate the risks that may color our value strategy.

Let us begin with the maturity of this bull market. The duration of this bull is on par with those of the past, although, the longer it runs, the greater the probability that we’re moving closer to the next bear market. Investors are faced with the countervailing stresses of inflation and weakness. It seems a regular occurrence that members of the Federal Reserve Board of Governors make speeches highlighting the Board’s continued vigilance against inflation. At each pronouncement, hopes for an early cut in interest rate targets get dashed again. Yet, overall economic growth has been less than optimal for three out of the last four quarters with the most recent reading coming in at only two percent real GDP growth. Are we at risk of the dreaded 1970’s “stagflation” returning, where twin problems of high inflation and sub-par economic growth exist simultaneously?

Many observers have commented that profit margins remain at peak levels. Does this imply margins are bound to head in a southerly direction? Not necessarily. The forces of globalization have allowed companies to outsource low value-added activities to

subcontractors who operate in lower-cost economies such as India and China. Might these moves shift the range of operating margins upwards on a semi-permanent basis?

The free-for-all that was the home mortgage marketplace now shows signs of tightening. The federal agencies with authority over the market have issued guidance on non-traditional mortgage product risks. This is a “shot across the bow” of lenders who play too loose with their lending standards. At the margin, this guidance will serve to tighten the entire housing market.

We have stated before that the consumer side of the ledger represents about 70 percent of GDP. With a reduced prospect of housing appreciation and the much debated current state of negative savings, the consumer has little in the way of untapped reserves to continue pushing the economy higher without substantial income increases. Also, the interest rate yield curve is mildly inverted, and historically, the longer this has remained in effect, the more likely a recession would ensue.

The still present 800-pound gorilla in the economy is the housing market decline, which most commentators will tell you, has not yet spilled over to affect the rest of the economy. To that we add one word . . . yet.

We conclude that the risks of a slowdown are too great to ignore. Will economic growth bottom out between zero and a positive two percent? That would result with *relatively* benign consequences. Negative economic growth, the definition of a recession, would be the worst-case scenario.

Our solution to this investing conundrum is to own stocks of companies that can fare better should such a slower-growth environment continue to unfold. We see no compelling “single decision” investment strategy. Rather, we focus on a few specific styles of strategies that work in complementary fashion.

First, we own a number of turnaround companies—that is, companies with unique, compelling factors that can produce earnings growth from achieving their planned turnaround improvements, which can occur despite any offsetting drag from a slower-growth economy.

Secondly, we own numerous companies that derive a significant percentage of their revenue from outside of the United States. The world has steadily become less dependent on the U.S. for growth than it has in the past, and thus, a slowdown in America does not necessarily imply an equivalent slowing in foreign economies. These companies can also benefit from the current weak outlook for the U.S. dollar, since foreign-denominated sales and earnings translate into a higher amount in U.S. dollars when the dollar weakens versus foreign currencies.

Also, we position the portfolios in companies with product line life cycle changes that will drive demand and sales growth. An example of this type of company is one going through a product or technology upgrade that can be readily adopted by their customers. We note that these life cycles are often easier to quantify for smaller companies than for larger ones,

because we can isolate our decision points about these cycle changes to a smaller number of variables.

And lastly, we look for companies whose sales outlooks are not linked to the rate of GDP growth. An example of this type of company is a late economic cycle business 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 will be spent.

Overall, we are in the middle of an economic cycle with a potential a risk of recession overtaking it, and with no compelling sector discount to buy into. In this kind of environment, we think it's all about stock selection, and that is something we pride ourselves on doing well here at ICM.

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## **Portfolio Performance**

ICM's Small-Cap Value portfolios' performance finished the quarter on average with the Russell 2000® Value Index and the Russell 2000® Index, which returned 9.03 percent and 8.90 percent respectively. The market's fourth quarter performance was a continuation of the rally that began in mid-summer, capping off a very successful year for investors in this market cap range. For the year, the portfolios overall performed slightly behind the Russell 2000 Index at 18.37 percent and the Russell 2000 Value Index at 23.48 percent.

In general, the portfolios, and both the Russell 2000 Value and 2000 Indices had strong quarters. Positive returns were seen in most sectors, with an especially strong contribution from the materials & processing, consumer discretionary and energy sectors. These encouraging returns were driven by our individual stock selection, as well as an overweight exposure to consumer stocks. Our strong performance in energy stocks was due to our exposure to companies with compelling new seismic research capabilities. Despite the recent drop in energy prices, oil producers are still in need of new and better tools to expand their abilities at locating and producing oil and gas on land and under the oceans. One of our positions benefited from the increased amount of merger activity currently seizing the market. More specifically, it was a materials & processing company, which had recently disappointed in its earnings release, forecasting earnings problems for the next few quarters due to an inventory overhang in its distribution channels. The stock jumped on speculation it was "in play" and we cut back the position. Shortly thereafter, an authentic offer appeared, and we then sold the remainder.

Health care was the least favorably performing sector in the portfolios, although our relatively low exposure to the sector did not significantly damage returns. The Russell financial services sector lagged the rest of the index, and so our sector bet against financials paid off. While we remain underweight financial services due to the high valuations we are seeing, we continue to look within that sector and will invest appropriately when we find compelling values.

The strong performance of the last few months has caused more than a few stocks in the portfolios to bump up against our target prices. This past quarter we selectively harvested stocks that were “ripe for the picking,” while reinvesting some of the proceeds back into new ideas where we expect more positive news surrounding these undervalued companies will be revealed over the next 18 to 24 months. Going forward, we maintain our disciplined approach of finding value and investing appropriately.

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