

LARGE-CAP/GLOBALLY DOMINANT COMMENTARY LETTER THIRD QUARTER 2007

PORTFOLIO PERFORMANCE

In very roundabout fashion, the S&P 500® Index provided a positive return in the third quarter of 2007. Credit concerns, largely related to the sub-prime mortgage mess, gave markets quite a scare in July, driving the S&P 500 down almost 12% in less than a month. The index managed to recover within the quarter to post a modest 2% return, and as this letter is being written, the S&P 500 Index is once again flirting with new highs as the fourth quarter gets underway.

The forces behind the equity market turmoil were closely related to those that initially surfaced in the first quarter of this year, and consequently managed to keep investors on edge throughout the greater part of the second quarter. Investors' worst fears came to fruition in the third quarter, when numerous hedge funds and large international banks realized that they were losing mountains of money in their credit market investments. Several prominent hedge funds were forced to inform investors that they had lost most of their clients' money on misguided sub-prime bets, and several well-known banks were forced to take big charges to write-down the value of their mortgage-backed investment portfolios. The Fed came to the rescue and dropped the federal funds rate by 50 basis points midway through September; however, not before equity markets had displayed some degree of stability on their own.

Our efforts to maintain a more defensive posture through the first part of the third quarter did pay off, as equity markets churned their way through the effects of the aforementioned sub-prime mess. Our underweight position in financials proved to be among the best decisions we made this past quarter, as banks and financial institutions seemed to be the primary victims of the mid-quarter equity market sell-off. Likewise, our decision to enter the quarter overweight in the consumer staples sector and the technology sector added buoyancy to our returns. Partially offsetting the positive effects provided by these sector weightings, was our decision to remain on the sidelines of the energy sector, as well as stock selections within the materials and consumer discretionary sectors.

Looking ahead, we see a distinct possibility for a stagnant interest rate environment, created by two equally formidable forces pulling interest rates in opposite directions. The falling dollar and the resultant reduction of the negative trade gap could drive economic growth and create fresh inflation concerns. While, on the other hand, additional sub-prime trepidation could continue to encourage monetary easing by the Fed. We are hesitant to make firm macroeconomic predictions either way, but are optimistic that large-

cap/globally dominant equity markets will forge ahead from here, buoyed by the strength in international markets. As a result, we are modifying our defensive posture. Our equity market optimism is supported by the fact that the S&P 500 Index is trading at a very low price-to-earnings multiple compared to historical tendencies. To take advantage of the perceived market upside, we are scaling back our exposure to the consumer staples sector and will be emphasizing investment opportunities in the industrial and consumer discretionary sectors with substantial international exposure.

As mentioned, our Large-Cap/Globally Dominant strategy will continue to concentrate on finding high-quality, industry-leading companies with broad international exposure. We look for businesses that possess sustainable competitive advantages, consistent financial results, and unquestioned market leadership, preferably with revenue growth in multiple international marketplaces. Such characteristics are often the attributes of companies with industry-leading returns on equity and free cash flow generation. Many of the companies appropriate for this strategy are household names with mature and highly recognizable brands. Others may not be globally dominant yet; however, if we see an unheralded competitive advantage that we feel could propel a company into a market leadership role, it will be an investment candidate.

The sector allocation process is a central area of focus and we will continue to thoroughly evaluate the macroeconomic forces that affect these allocation decisions on an ongoing basis. Our focus remains on searching for the best performing and most dominant companies available within our targeted sectors, as well as continuing to monitor those companies that appear to be developing a sustainable competitive advantage that will result in eventual long-term market leadership. As always, our goal is to give our clients high-quality participation in a portfolio comprised of companies that provide global representation and the best the world has to offer.

ECONOMIC OVERVIEW

In the third quarter of 2007 the U.S. economy finally started to recognize the issues overhanging the residential mortgage market. This in turn led to a setback for the entire credit market structure, as credit spreads for low quality debt quickly widened from what had been unsustainably low levels. The stock market reacted in sympathy to the bond market, selling off on the bad news. While the stock market recovered in the latter part of the quarter due to improved psychology, thanks to the Federal Reserve, the economy itself has continued to flash mixed signals about the future.

After showing marked slowing in the first quarter, GDP rebounded in the second quarter to an annualized growth rate of 3.8%. While this is an acceptable growth rate for an economy as mature as America's, the signs indicative of future economic growth are faint. Leading economic indicators have been weak all year, see-sawing between positive and negative at every reading. Housing starts have declined, even as the inventory of unsold

houses, as measured in number of months, has shot up to peak levels. And, the U.S. dollar has drifted lower as it continues to lose ground to other currencies around the world. However, all is not negative. Employment levels remain strong, as the unemployment level remains under 5%, and exports from the United States have grown noticeably of late, helped in part by the lower dollar.

Forecasting the future of this economy is always full of uncertainty. Framing this task by looking at what has transpired might make matters clearer. Generally speaking, since the end of the recession in the early part of this decade investors have been willing to accept progressively higher levels of risk because the downside to that risk was seen as too far into the future, while the concomitant high returns were “close at hand”. This past summer risk once again became a four-letter word. When “the music stopped” it became apparent just how creative the merchants of debt had become on Wall Street. They even went so far as to issue huge amounts of commercial paper, historically a short term debt instrument for credit worthy borrowers, to back the purchase of exotic mortgage products (a long term debt instrument if ever there was one). As the anecdotal stories pile up, the central question on everyone’s mind is “who’s holding the bag” and how big is that bag? We have seen various estimates of the size of the sub-prime mortgage market, as well as how much of it can be expected to default. While it will take time to answer those questions, we can expect certain consequences:

- Some borrowers who previously had easy access to credit will be denied it; now that it is clear they should not have been lent money in the first place to buy properties they could not afford.
- New borrowers who never had the chance to play this roulette game with the bank’s cash will be denied the opportunity.
- Aggregate demand for residential property will sag for a period of time, and prices no doubt will also sag.
- Banks will get more conservative about how much they will lend on home equity loans, which will serve to dampen consumer spending as the home equity “ATM machine” phenomenon slows.
- Various businesses seen as derivatives to the housing boom will suffer newly below trend sales, such as home improvement businesses and building materials companies.
- In the short-term the highly leveraged, go-go acquisition marketplace for private equity is taking a siesta, at least for now.

Still another uncertainty is the longer-term effect of all this on the high yield debt market, and the whole process of capital formation for less credit worthy corporate borrowers. While much has been made of the paralysis exhibited by the credit markets, it is important for us to distinguish between those factors that are the more mechanical aspects of the economy, from the truly fundamental factors that drive GDP over time.

The biggest drag on economic growth for the foreseeable future is the continued unraveling of the housing market. We expect housing starts, and the related economic activity they engender, to trend down for now. Foreclosures and delinquencies will tick up, as unsold inventories peak, and then work their way down. Along the way, house prices will recede to an extent sufficient to allow the market to reach equilibrium, at which point housing starts will begin to recover, supported by the natural demand that accompanies a growing population in the U.S.

The impact of this correction will affect the homebuilders themselves and their workers and suppliers, as well as all the people and firms involved in home mortgage finance, from real estate brokers to intermediaries on Wall Street. As we discussed in last quarter's letter, a significant part of consumer spending growth so far this decade was attributable to rising real estate prices and the home equity extraction it permitted. In the "new realty reality" we expect the consumer side of the economy to face a continued headwind, which will have to be offset by other parts of the economy.

Partly offsetting this trend is the positive news in employment, which is still growing, though slowly. The downtick in employment originally reported for August was revised up when September's figure was reported. The unemployment rate held firm at 4.7%. Though this is a lagging indicator, it is a key to seeing continued economic expansion.

As widely reported, the U.S. dollar has weakened, since the recent Federal Reserve interest rate cut. This is not a critical problem presently, but if it continues to erode it could be. For now, a low dollar is making our exports more competitive. We should see better traction for U.S. exporters now that the dollar is down. We also expect to see reduced imports, as the lower dollar would serve to increase the price of imported goods and thus retard weak consumer spending further.

Overall, we see slower, less predictable growth ahead for the U.S. economy, with companies having significant foreign sales being at an advantage over strictly domestically oriented firms. This is reflected in our continuing emphasis on technology and proprietary producer durables.

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