

LARGE-CAP 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. Yet, we are aware the flow of easy money supporting the buyout mania can dry up rather quickly.

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 POSITION AND PERFORMANCE

The market as measured by the S&P 500® Index quieted all skeptics during the second quarter, **gaining 6.28%**. In spite of continued conservative positioning, the ICM Large-Cap Core strategy outperformed the index during the quarter (client performance varied due to account size, individual client mandates, and client restrictions).

The gains enjoyed in the markets came in spite of a strong rise in the yields on U.S. Treasury securities; the 10 year U.S. bond rose from 4.65% at the end of the first quarter to more than 5% by the end of June. While rising rates impact the costs of borrowing, the



greater concern is the discount rates used in valuing equity securities (where rising discount rates indicate falling “fair” value of equities). Additionally, as private-equity activity feeds speculation regarding likely buyouts bolstering share prices, rising rates often spell the end of the “easy borrowing” period, making such take-outs possible. So far, however, credit availability continues to be spectacular and private-equity deals are announced almost daily. Action outside of interest rates was slightly negative for share prices, oil rose nearly \$5 per barrel late in the quarter while the U.S. Dollar continued to weaken, relative to most major currencies, discouraging foreign investment in U.S. equities. The markets collectively shrugged such moves, however, and surged onward in the quarter.

U.S. homebuilders continue to report weak bookings and sales activities. Sluggish volumes are finally starting to come home to roost in terms of profits, with many builders posting losses for the first time in years. As we have previously written, the levels of foreclosures and lending availability will be key as the U.S. economy moves through this period, and the likelihood of economic recession will be driven more by housing than any other single arena. During the quarter a large Wall Street Hedge fund, operated by one of the nation’s largest investment banks, required a large capital infusion due to its loss experience in the sub-prime lending environment. So far, capital has been willingly committed to prop up such losses in order to continue the operation for the potential of future profits. But, if capital dries up, such activity will no doubt lead to a downward spiral in activity as consumers of questionable credit will have fewer opportunities to reconstruct their balance sheets and avoid foreclosure. We continue to monitor the housing environment closely.

As we have written in the past, we continue to believe that the best large-cap value in the marketplace today is found in the blue-chip companies within the S&P 100®. It seems investors can forget why these companies have developed the strength they enjoy today: strong brand names, scaled production and development efforts, high free cash-flow generation, growth in revenue and earnings, and solid balance sheets with ample cash reserves. Historically, it has been wise to acquire companies with these attributes, particularly if they can be bought at bargain prices. The ICM large-cap portfolios continue to be heavily weighted in these opportunities.

During 2006 we wrote consistently regarding four key themes scattered throughout the ICM large-cap portfolios: over-weighted positions in technology companies, strong weightings in pharmaceutical businesses, overweight positions in consumer staples companies, and under-weighting in energy related businesses. During the second quarter we remained committed to these key themes. The first quarter, however, was unique in that these four key themes were not the primary drivers of our investment performance. These themes had a greater impact during the second quarter, particularly noticeable when considering the companies within each theme. Most of the out-performance in the quarter came from good stock selection inside these four distinct themes. One of those investments, a major information technology company that provides computer systems and



services worldwide, delivered strong returns in the quarter, and was responsible for much of the quarter's out-performance. Finally, even though performance was roughly in-line with the benchmark last quarter, we noted a few companies that had a strong, negative impact on our performance. We continue to believe strongly in these four themes, and are confident that we have chosen the right investments in each theme to deliver good returns in your portfolios over time. It is encouraging to see a quarter like this occasionally to boost those convictions. Please refer to our fourth quarter 2006 letter for a discussion of the four key themes (a copy will be made available upon request).

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, if you have any questions or need additional information.

