

LARGE-CAP CORE COMMENTARY LETTER THIRD QUARTER 2005

After the Storms . . . Keeping our Eyes on the Belly

Economic Overview

In recent discussions with clients and our investment team, a phrase from my high school football coach's daily lecture comes to mind: *Keep your eyes on the runner's belly or the head fake will get you every time.* We believe this is a key fundamental of defensive tackling and quite relevant to the current state of the markets.

As we have mentioned in previous commentary letters, we have many concerns about the present state of the U.S. economy, primarily related to the consumer. Specifically, we feel that consumer spending will slow and the markets will continue to muddle along. We do not feel that a recession or a steep correction in the equity market is imminent. However, we do believe that caution is warranted and that downside risks remain equal to or greater than upside potential.

Despite our concerns, the S&P 500 Index posted a gain of 3.6 percent for the quarter. Alone, this was not surprising, but in the face of the worst natural disasters in recent U.S. history, bankruptcy filings by two of the largest U.S. airlines, and record high energy prices, the equity market remained surprisingly stable. We feel that the market's resilience is reflective of too much complacency, with the current optimism surrounding the fiscal stimulus driven by disaster relief spending. We believe the market has lost sight of the economic run's proverbial "belly," and may be falling for the head fake in light of the broad economy's decline.

The Consumer . . .

As the equity market rose, the U.S. consumer's discretionary income moved lower as a consequence of higher interest rates, higher energy costs, and a prospective cresting in the trend of home price appreciation. Interest payments and energy costs now represent almost 20 percent of after-tax disposable income, which is the highest margin in 25 years. Household debt now represents a record 124 percent of personal disposable income, and during the quarter, consumers continued to further cut back on savings, with the rate declining to -0.7 percent. Obstacles for continued growth in consumer spending are clearly mounting. We have thought for some time that the inability of consumers to continue to monetize home equity appreciation would precipitate a spending slowdown; however, it now looks as if just the sheer level of debt itself may slow spending. This is even more likely if income growth (net of inflation) remains at distressing 14-year lows. Also, consumers face an additional squeeze on the credit front due to the mandated increase in credit card minimum payments (essentially double from two percent to four percent) by the Comptroller of the Currency. Merrill Lynch estimates that higher minimum payments could add an additional \$25 billion to household debt service.

The Housing Market . . .

As we have discussed in previous commentary letters, economic growth for the past four years has been driven by the consumer and fueled by the housing market. While housing only represents five percent of the total economic output, Merrill Lynch estimates that the housing market has contributed to 50 percent of economic growth in the first half of 2005, and since the fall of 2001, perhaps 60 percent of new jobs created have been related to the housing boom. Easy access to home equity has also driven consumption at the margin, which has been multiplied by the ability to refinance multiple times as home prices have continued to rise (see table below). Furthermore, loose credit has enabled home owners to purchase homes with zero down and artificially low payments via alternative mortgages such as adjustable rate, negative amortization, and interest-only. It is estimated that these alternative loans now represent a substantial portion of new loans as buyers stretch for higher priced residences. Importantly, these home mortgages have enabled consumers to spend the excess money on luxury items such as plasma televisions or new cars, which would have traditionally funded 30-year mortgages.

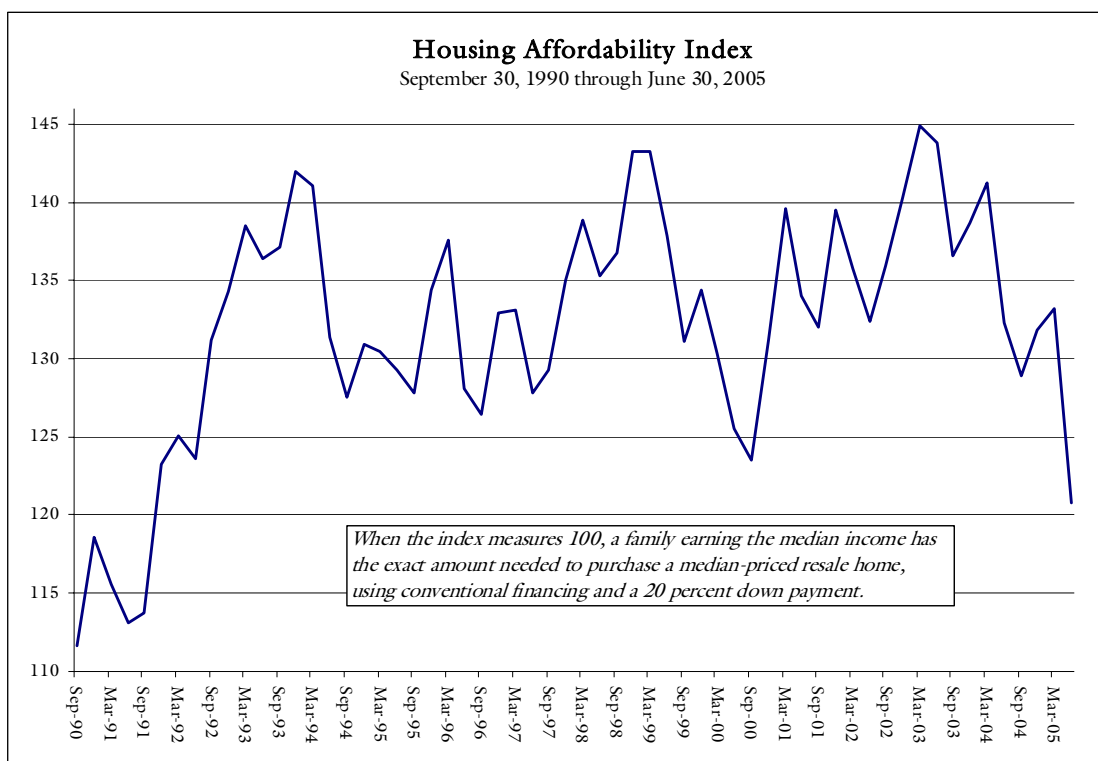
Annual Cash-Out Percentage For All Prime Conventional Loans Freddie Mac Cash-Out Refinance Report Q2 2005			
Year	Cash-Out Dollars as a Percentage of Refinanced Origination Amount	Total Home Equity Cashed Out (\$ billions)	Volume of Cash-Out and Second Mortgages/HELOC Consolidation (\$ billions)
2001	8.7%	\$82.9	\$135.5
2002	8.0%	\$111.1	\$170.5
2003	7.2%	\$146.9	\$224.4
2004 (E)	13.1%	\$139.6	\$182.0
2005 (F)	18.1%	\$161.6	\$200.0

Source: Freddie Mac

Perhaps surprisingly, we are not preoccupied with concerns about a housing bubble or a correction in home prices. We are now worried about the potential economic effects of a simple leveling out of prices. Our fears are derived from the recent experience of Australia and the United Kingdom. In the recent past, both economies have enjoyed a housing boom induced by low interest rates and sustained by skyrocketing home prices. In the U.K., prices peaked at 22 percent in year-over-year (y-o-y) growth during June 2004. Growth now sits at one percent y-o-y. It may appear as if no real correction happened; however, the true correction came in consumer spending and GDP growth, which have dropped from 7.4 percent to 1.7 percent and from 3.7 to 2.1 percent, respectively. Australia's housing market tells a similar story. Their housing market peaked in December 2003, at 19 percent y-o-y growth and prices are now flat. Again, similar to the U.K., consumer spending growth plummeted from 8.2 to 3.2 percent and GDP growth slowed from 4.5 to 1.9 percent.

In order to understand where the U.S. housing market may be headed, we look at the affordability ratio (see chart on the following page), which now sits at its lowest point since 1991, primarily driven down by higher home prices that squeeze out the average buyer. Evidence of this has appeared in both the University of Michigan's Home Buying Intentions survey as well as the National Association of Home Builders (NAHB) Index, which have now

both fallen to multi-year lows. Within the NAHB, the expectations portion of the index recently experienced its largest decline since September 2001.



Source: Bloomberg

Conclusion . . .

Collectively, the state of the consumer is troubling, especially since the consumer now represents over 71 percent of our economy, relative to the average 67 percent from 1975 to 2000. We expect that this trend will reverse as housing stalls, debt mounts, and income fails to meet expectations.

Generally, this is negative for both the U.S. economy and the world economy, as it too is highly dependant upon U.S. consumption. However, as the U.S. has consumed and overspent, the consumer health of Japan, Europe, and China look much better (see table on the following page). Additionally, corporations in the largest economies of the world have been highly profitable, and remain net savers and lenders.

Global Savings and Consumption		
	Consumption as a % of GDP	Savings Rate
U.S.	71.0%	-0.7%
Japan	55.0%	14.0%
Europe	58.0%	8.0%

China	42.0%	35.0%
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Source: Morgan Stanley & Merrill Lynch

In total, Europe, Japan, and China represent 35 percent of global GDP relative to the U.S. at only 21 percent. Therefore, if U.S. consumption does begin to slow, other areas of the globe may pick up the slack. It is this reason that our outlook remains modestly positive for global equities and in particular, emerging markets over U.S. equities. Although, the real unknown is how greater consumption abroad would affect U.S. interest rates. Many pundits believe that excess global savings has sustained demand for our government debt. Clearly, something is keeping the 10-year Treasury yield low, as it has remained essentially flat while the Federal Reserve has raised its discount rate 11 times from one percent to 3.75 percent. In the meantime, we remain conservative in our investment approach, and maintain our defensive stance: keeping our eyes on the belly.

Portfolio Performance

In the third quarter of 2005, the Large-Cap Core portfolios showed modest gains although behind the 3.61 percent for the S&P 500 Index and the Russell 1000® Index with 3.95 percent. It is noteworthy, however, to point out that the performance of the broad market indices would be negative this year without the contribution of a strong energy sector. Our portfolios were generally impacted by two significant factors in the quarter: an under-weighted position in energy and energy services, and an over-weighted position in large pharmaceutical companies.

With a strong energy sector, our portfolios are impacted two ways. First, we have less energy weight than the major indices; and second, the companies we own in the energy sector are considered “blue-chip” and do not perform to the same magnitude in an energy up-cycle. However, as we have said in the past, we continue to believe the energy patch will be cyclical, and are content to have our capital invested in the major integrated oil companies. These large, diversified, and well-run companies are able to weather the cycles over the long haul.

Portfolio Activity . . .

During the quarter, we continued to build on our investments in large pharmaceutical companies. While these companies continue to deliver strong earnings and cash flows, investors have lately viewed the glass as half empty. Meaningful concerns regarding an apparent lack of invigorating products in the pipeline, fears about governmental pricing regulation, and a focus on litigation risks have all pressured the shares of these large companies. It is difficult to judge the quality of a drug pipeline — sometimes drugs with slim chances of development become blockbusters, and sometimes those with high expectations never get out of the labs, which is usually the case.

The U.S. pharmaceutical industry has led the world for decades in drug development. Although many today protest that drug prices are too high, none seem to complain about the availability of many life-saving and enhancing drug alternatives. Some estimate that it costs in excess of \$750 million to develop a drug and deliver it to those in need. Healthcare services and products, regardless of treatment and delivery mechanisms, are expensive and inflationary. Some view pharmaceutical products as contributors to these rising costs. We, however, view pharmaceutical products as a key solution to long-term healthcare costs, since the preventative mechanisms provided by prescription drugs are far lower in cost than in-patient treatment alternatives. (If you think cholesterol is expensive, compare it to the costs of

open-heart surgery.) No doubt, investor and consumer sentiment in this area will waver over time.

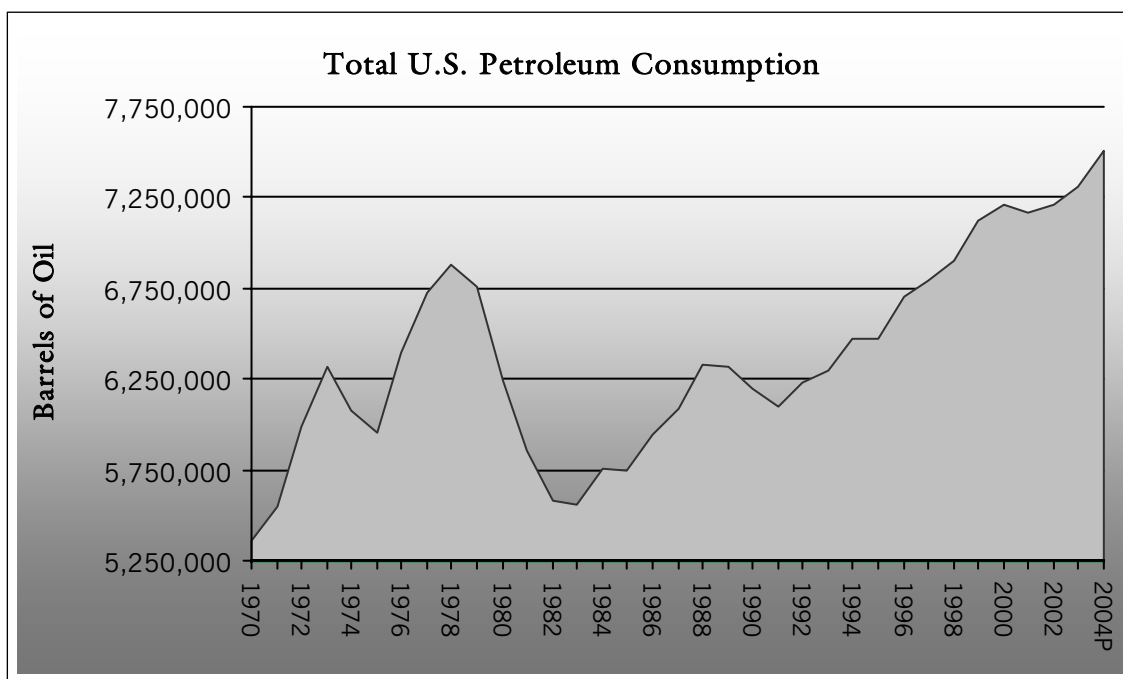
In addition to fortifying our pharmaceutical weightings, we also sold positions in the Energy Services sector and built positions in the Consumer Staples sector. As you know, we sell shares when our internal price targets are met, when value has declined, or when we have better companies to buy.

Our purchases in Consumer Staples came to us at attractive prices. The companies we purchased have excellent managers, strong dividend yields, attractive brand profiles, and reinvestment opportunities that we believe will drive consistent growth over the long-term. Additional allocations within this sector are also defensive in nature. As we highlighted in our economic outlook, we may be at a time in the economic cycle where growth is slowing. In times of potential market weakness, consumer staples companies tend to outperform other sectors of the economy. As illustrated in the table below, this performance during profit weakness is most consistently demonstrated by the food retail and foods industries within the Consumer Staples sector, with an average out-performance of 20 and 36 percent, respectively.

Relative Performance of Consumer Staples Industries During Periods of S&P 500 Profits Deceleration (Peak Earnings Growth to Trough)								
	12/73	9/79	6/84	6/88	3/95	3/00	Average Out- (Under) Performance	Periods of Out- Performance
	9/75	12/82	12/85	12/91	9/98	12/01		
Food Retail	37%	7%	16%	15%	6%	37%	20%	6 out of 6
Foods	19%	23%	44%	79%	-18%	68%	36%	5 out of 6
Household Products	6%	13%	5%	47%	-5%	43%	18%	5 out of 6
Tobacco	17%	34%	-11%	213%	-12%	150%	65%	4 out of 6
Drug Stores	0%	87%	-5%	-3%	135%	30%	41%	4 out of 6
Bev - Non-Alcoholic	-27%	7%	16%	174%	-3%	32%	33%	4 out of 6
Bev - Alcoholic	-49%	84%	34%	31%	-45%	66%	20%	4 out of 6
Personal Care	-17%	-46%	4%	71%	-23%	32%	4%	3 out of 6

Source: Standard & Poor's & Merrill Lynch Quantitative Strategy

Our sales in the Energy sector were based on the price targets being met (in fact well exceeded). While there is much hype regarding energy prices and demand today, we believe that the energy patch will continue to deliver cyclical results. Over time, there will be good years and bad years: periods of rising demand and price levels followed by periods of slow demand growth and declining prices. Most people remember our last major spike in oil prices in 1978; however, many people don't realize that petroleum consumption in the U.S. did not return to 1978 levels for 20 years (see chart on the following page). Most importantly, we suppose that in 1978, many economists and analysts estimated that consumption would continue to grow at its current breakneck pace. Selling shares based on valuations reflecting this "growth" forever seemed like a good idea to us during the third quarter. We will happily quench any doubtful questions about short-term results, and are strong believers that over time, our purposeful actions will prove sound. As you know, the team retains an investment focus, and does not wander into speculation.



Source: U.S. Department of Energy

One of the largest operators in the energy field seems to share our opinion and estimates that nearly seven trillion barrels of oil exist in the world today in a conventional sense (of which approximately two trillion barrels have been consumed). An extra five trillion barrels are found in tar sands. Less is known about available stores in oil shale, but today's estimate is in excess of three trillion barrels. Each day nearly 85 million barrels of oil are consumed throughout the world. This means that at current consumption rates, the world has approximately 419 years of oil remaining. While we expect the demand for oil to continue growing, we also fully expect the oil business to remain cyclical, and have evaluated our investments in this light.

Looking Forward . . .

From a defensive perspective, keeping one's eyes focused on the belly is essential to avoid falling for the head fake. From an offensive perspective, one wants to find areas of weakness in the defense and exploit them. For us, this means identifying attractive catalysts within the large-cap marketplace. Given our discipline of being attuned to defensive and offensive elements, of blocking and tackling, and of weaving our way through the various details of investing, we believe your portfolio is well suited to capitalize on our efforts.

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