

# LARGE-CAP EQUITY COMMENTARY LETTER FOURTH QUARTER 2005

## *Scaling the Economic Peaks*

---

### **Economic Overview**

It is once again that time of year when investors commence looking backwards and forwards simultaneously. With one foot in the past and one pointed toward the future, it's easy for forecasters to lose their balance. Our objective is to correctly evaluate past trends to determine how they will behave in the future. The interplay of economic cycles that are continuing, plateauing, or peaking will ultimately determine investor satisfaction in 2006.

This is an interesting time to make predictions. Many of the economic trends that will impact investment returns in 2006 have been underway for substantial time periods (in some cases several years to a decade), so predictions of their reversal are not without their detractors. It is also true that established trends have their own natural momentums that resist change. Nonetheless, we believe that reversals of some of these trends are highly likely this year and the approach to these changes will be important to our portfolio strategy. What follows is a brief discussion of those trends.

### **Consumer Spending . . .**

About 70 percent of total U.S. Gross Domestic Product is attributable to the consumer, so accurately assessing their behavior is essential to success in forecasting 2006. Here are the key issues as we see them:

1. Consistent income growth is central to healthy consumer behavior. Unfortunately, we do not think the results of the last few years measure up to the necessary standards. Quality job growth has been marginal. Growth in the number of jobs has been less than what is preferable in a recovery (we estimate 1.5 million per year as opposed to 2.25 to 2.5 million) and much of the non-farm job creation has been in the peaking residential housing business.
2. The appreciation in home prices since the peak of the U.S. equity markets in mid-2000 has remained, in our opinion, the single most important driver of economic growth for the past five years. Equities have recovered nicely since early in 2003, but consumer balance sheets benefit much more from home appreciation than equity appreciation. If home prices cease rising as we expect, the ability of many consumers to restore their liquidity will disappear and spending patterns will slow.
3. Energy prices remain another hurdle for the American consumer in '06. The winter heating season has been considerably warmer than normal (roughly 20 percent warmer), so this problem has so far had less impact than would have been the case with a colder winter. Nonetheless, consumers are still paying considerably higher prices. This will continue to burden their budgets, especially if winter returns to normal temperatures.

In summary, when it comes to consumers, virtually all of the changes in trends are far more likely to be downward revisions. It is a core assumption for ICM that the consumer is

peaking as a key driver of economic growth in the coming years. It is still a bit early to argue whether this is a peak or a plateau, but deceleration is a distinct probability.

### Government Spending . . .

Uncle Sam has also been an important contributor to economic expansion over the last several years. More stimulative federal spending made sense as the equity bear market grew more threatening in '02 and '03, but this stimulus was increased with the accelerating demands of an aging population, the war in Iraq, and Gulf Coast reconstruction. It is very unlikely that the federal government can incrementally increase its degree of stimulus above the current level. Tax receipts will continue to trend higher, but not at a rate appreciably above spending increases. It seems even less likely that Congress can sell the idea of expanding the current deficit in the face of mid-term elections; therefore, government spending will at best plateau as a contributor to economic growth in 2006.

### Corporate Spending . . .

Corporations have experienced historically high levels of profitability in recent years. The result is generally healthy balance sheets. This could conceivably play out in several ways in the immediate future, but two of the most likely possibilities would seem to be higher dividends or increased capital spending. We do not see much support from corporate managements to increase dividends, although we do believe that healthy profitability and strong balance sheets will lead to a positive capital spending environment in 2006. The critical issue, however, is where those dollars will be spent. Many of these dollars will be invested overseas in low-wage emerging markets, and the spending pattern will likely be quite irregular across industries. The key to success will be to identify the right sectors and companies that will benefit from this capital spending.

### International Effects . . .

The important international swing factors for the U.S. equity markets are probably the most difficult to evaluate. Significant changes in the exchange value of the dollar would impact our markets, but at present, we do not feel confident about predicting any change in recent trends. Longer term though, one should not forget that the U.S. is becoming increasingly dependent on the import of foreign capital. Any disruption of these inflows would have negative consequences.

The other significant trend for international markets that bears watching is the U.S. trade or current account deficit. It continues to grow and is now so large that it would be considered a significant problem for a smaller economy. The counter argument offered up by some economists is that the U.S. economy is so large and powerful that our nation's deficit is not a risk. We are not particularly reassured by this viewpoint. A potentially positive aspect of our earlier prediction of slowing consumer spending would be a moderation of the trade deficit, which we believe is heavily consumer driven.

With this general perspective on the key issues of 2006 as a backdrop, here are our thoughts on your Large-Cap equity portfolio.

---

## Market Overview

Compared to the numerous events of the third quarter, 2005's final quarter seemed somewhat uneventful. The hurricanes and increased energy prices earlier in the year gave way to modest oil prices, interest rate volatility, and relatively tame economic news. Equity markets responded with a modest advance of 2.09 percent for the S&P 500 Index, putting the total return for the year at 4.91 percent. Despite this advance, we continue to maintain a fairly watchful view of the equity markets. We believe that the steadily growing and healthy economy is offset by a few challenges. The general levels of consumer indebtedness and overspending, post-retirement benefit obligations, derivative market counter-party risk, and the widespread use of credit derivatives all can be causes for concern. ICM's focus remains on discovering companies that trade at discounts to intrinsic value and those that offer margins of safety in light of our cautious market outlook.

---

## Portfolio Position and Performance

Since 2003, the equity markets have rebounded strongly from the excesses of the technology bubble and the economic weakness following September 11<sup>th</sup>. However, underlying this broad strength, a divergence of performance has arisen between the largest companies in the S&P 500 (the S&P 100) and the smallest companies in the index. The performance of the broad S&P 500 has masked true weakness over the last two years in the largest U.S. companies. Since early 2003, the cumulative total return of the S&P 500 has been an impressive 49.65 percent, while the larger S&P 100 produced a lesser return of 35.95 percent. As highlighted in the table below, this performance differential was most extreme during 2004 and 2005, with the S&P 100 producing about half the return of the S&P 500 in 2005, and just over half the return in 2004.

---

### All Large Companies Are Not Created Equal!

	2005	2004	2003	Cumulative Return	Annualized Average Return
S&P 500	4.91%	10.84%	28.67%	49.65%	14.38%
S&P 100	1.19%	6.41%	26.24%	35.95%	10.78%
<i>Underperformance</i>	<i>-3.72%</i>	<i>-4.42%</i>	<i>-2.43%</i>	<i>-13.70%</i>	<i>-3.60%</i>

*Source: Bloomberg, LP*

---

We have found this trend intriguing—the S&P 100 significantly overlaps the S&P 500 (it represents nearly 57 percent of the S&P 500). Additionally, both indices are designed to have similar sector weightings. The primary differences between the two are the size of companies and that the S&P 100 contains the most established companies from the S&P 500. These characteristics are similar to ICM's portfolios. We also place emphasis on companies with strong business models, high returns on invested capital, and consistent free cash flow.

To understand the weak performance of the S&P 100, we deconstructed the S&P 500 by sector, industry, and company. What we found was that while most sectors performed well over the past three years, there were distinct winners and losers within most sectors.

Within the table below, we have outlined sector and sub-industry performance of both Energy and Health Care. Within the Energy sector, all sub-industries have been strong; however, the oil and gas refiners and explorers performed extraordinarily, posting 79.20 and 66.40 percent returns, respectively. Both of these sectors have virtually no representation in the S&P 100 or within our portfolios for that matter. On the other hand, the industry prominently represented in the S&P 100 is integrated oil and gas, which posted the mildest gain in the S&P 500 Energy sector. We remain cautious on these most aggressive industries within Energy, which boils down to all companies but the major integrated companies. As Table Two indicates, share prices have soared, yet the sector remains quite cyclical. As we have written in the past, ICM continues to expect cycles of good and bad times in energy investing. We believe that many companies' share prices reflect overly optimistic opinions about the future and are somewhat ignorant of their historic cyclicity.

**TABLE 2: The Haves (+) and the Have Nots (-) ...**

	2005	2004	2003
<b>S&amp;P 500 ENERGY INDEX</b>	<b>31.37</b>	<b>31.44</b>	<b>25.63</b>
Integrated Oil & Gas (-)	17.63	28.74	26.71
Oil & Gas Exploration (+)	66.40	34.75	23.65
Oil & Gas Equipment	48.57	31.76	24.74
Oil & Gas Drillers	53.43	44.99	6.66
Oil & Gas Refiners (+)	79.20	64.01	58.97
<b>S&amp;P 500 HEALTH CARE INDEX</b>	<b>6.46</b>	<b>1.67</b>	<b>15.06</b>
Pharmaceuticals (-)	-3.36	-7.41	8.78
Health Care Equipment	0.05	12.58	32.04
Managed Health Care (+)	42.70	52.64	41.34
Biotechnology	18.28	7.58	28.86
Health Care Services (+)	32.37	17.55	N/A
Health Care Distributors (+)	29.26	-2.53	8.18
Health Care Facilities	11.47	-10.08	5.38
Health Care Supplies	17.40	21.40	36.91

Source: Bloomberg, LP

The broad Health Care Index returned 6.46 percent for 2005. The sub-industries of managed health care, services, and distributors posted returns of 42.70, 32.37, and 29.26 percents, respectively. The weakest health care industry has been the pharmaceutical sector, which coincidentally, is the most prominent health care industry in the S&P 100. As we have mentioned before, our Large-Cap equity team continues to find good values within the pharmaceutical industry. These companies offer attractive yields, an excellent history of allocating free-cash flows at superior returns on investment, and relatively low current multiples of free-cash flow; therefore, we believe these investments will prove sound over time. Not surprisingly, due to their poor performance of late, they are not popular investments in today's marketplace and we are aware of the likely declines in revenue over the next few years from several major drug brands. However, we have recently been encouraged by some significant cost-cutting initiatives and dividend payment increases announced by portfolio companies. We remain confident that in time, research labs will develop the necessary drugs of tomorrow and prove today's share prices a bargain.

We continue to follow a disciplined strategy by investing only when prices offered in the marketplace fall below our estimates of intrinsic value and thus, have positioned your portfolios accordingly.

---

*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.*

