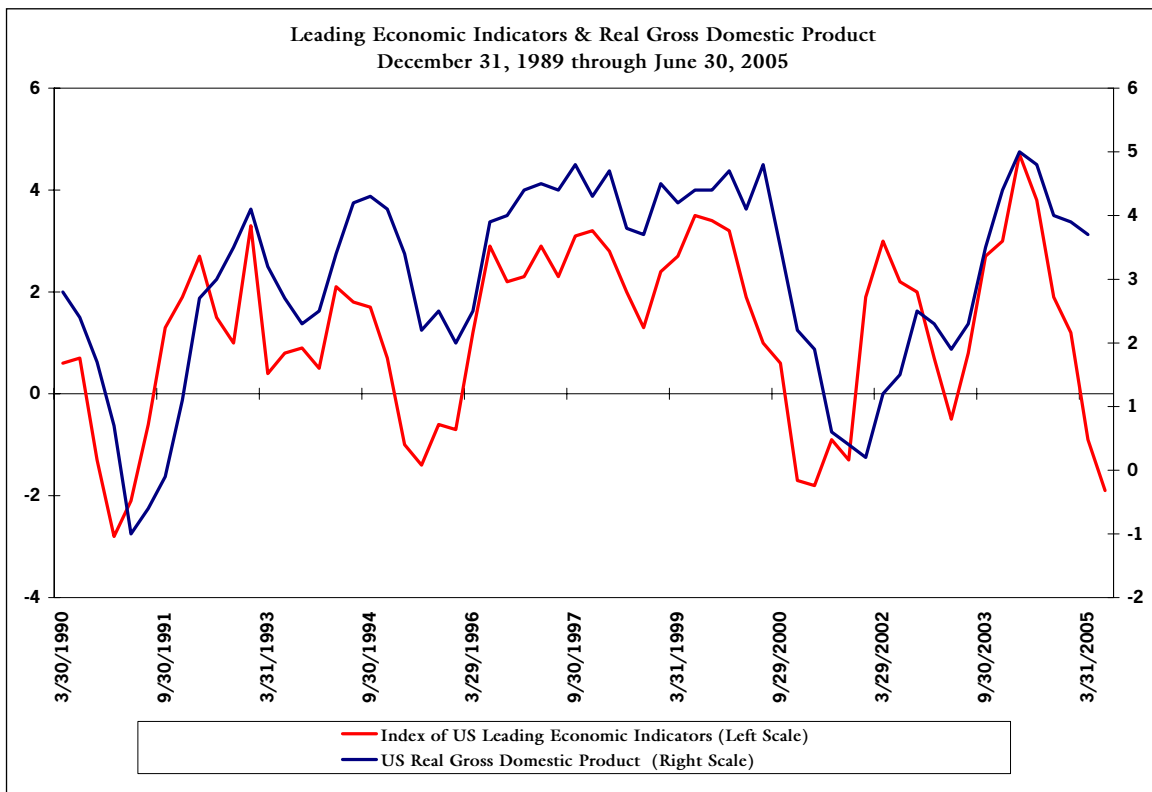


# SMALL-CAP VALUE COMMENTARY LETTER SECOND QUARTER 2005

## Current Market Environment

Over the past three years, the U.S. has been drenched in economic stimulus. From increased government spending and tax cuts, to historically low interest rates, the stimulus pumps have been working overtime—the good news is that economic growth over this period has been strong (stronger than we had estimated) with the engine of growth being the U.S. consumer and the primary fuel being rising home prices. The wealth effect of higher home values and equity cash-outs has driven consumption at the margin and thus, the U.S. economy as a whole. According to *The Economist*, “Two-fifths of all American jobs created since 2001 have been in housing-related sectors.”

Unfortunately, the economy remains reliant upon these imbalances to fuel future economic growth. Consequently, all arguments for continued strong growth are defensive; market bulls are using a higher, longer argument generally based upon lagging economic indicators (i.e.; GDP growth and corporate earnings). However, the index of leading economic indicators (see chart below) has been flat or down for five straight months, and currently stands at -1.9 percent trailing one year from May. This trend is significant. According to Merrill Lynch, “Fully 90% of the time in the past, year-on-year declines in LEI spelt an upcoming slowdown or outright downturn.”



Source: Bloomberg

However doubtful we at ICM are, consumer spending has remained resilient. During the first five months of the year, personal spending exceeded personal income growth in four of the five months. Bullish market commentators continually point to the low unemployment rate and the rate of hiring as the drivers of sustained growth going forward. Viewed separately, these statistics are quite impressive with the unemployment rate at five percent—about the level prior to September 11, 2001. However, wage growth (net of inflation) is currently growing at its slowest rate in 14 years and is well behind the wage growth of previous economic expansions. In fact, the inflation-adjusted hourly wage is lower today than the prevailing rate at the recession trough of November 2001. The trend of saving less to fund consumption will ultimately end with the cushion of personal savings at a lowly 0.4 percent. This reality has only been postponed as a result of higher home values, which have improved consumer balance sheets.

While these trends are disconcerting, we do not anticipate an abrupt correction or downturn in the equity markets. In fact, the most likely scenario is continued drift in both economic and equity market performance.

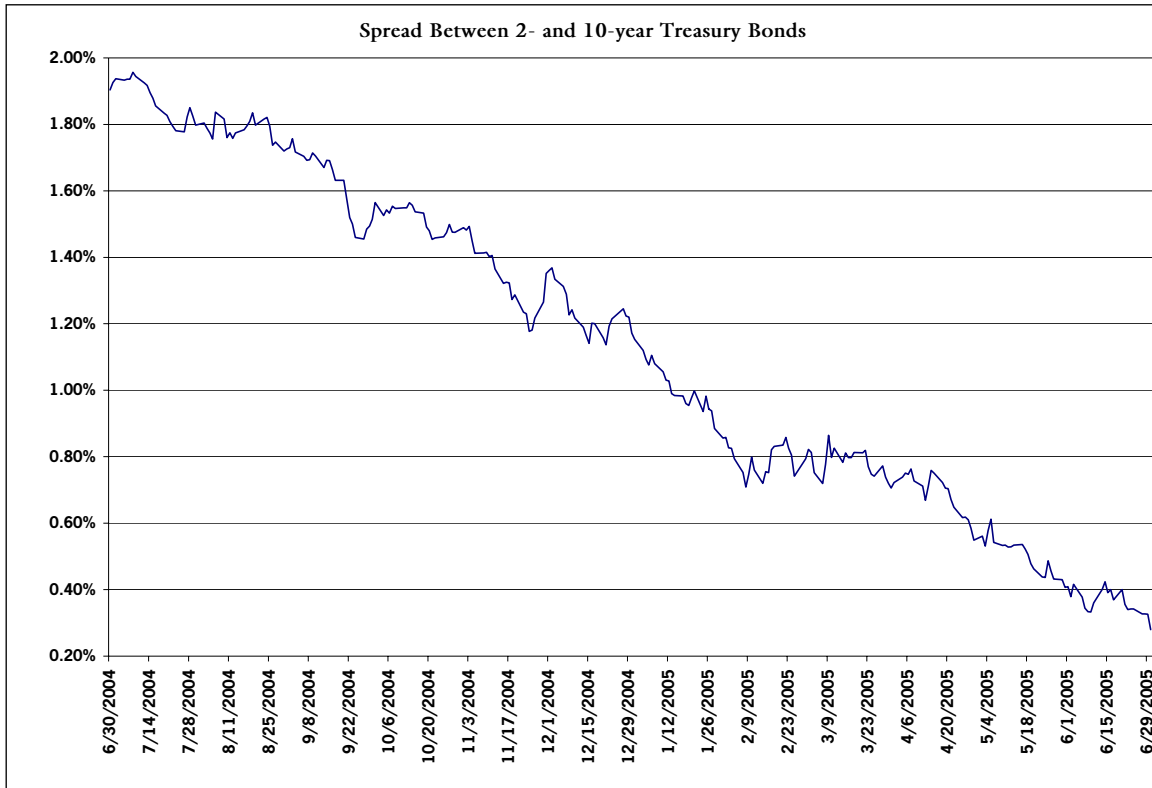
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## **Portfolio Performance**

During the quarter, the market rallied as small-cap stocks overtook large-caps, with the Russell 2000® Index gaining 4.32 percent. The five-year trend of value over growth was sustained as the Russell 2000® Value Index was up 5.08 percent. However, an interesting shift within the Russell 2000 took place this quarter. When one examines the Russell 2000's performance, the surface numbers are deceiving, as the cheapest companies from a price-to-book and price-to-sales basis underperformed the broad index, this being contrary to the Russell 2000 Value Index outperforming the more highly valued Russell 2000. ICM's Small-Cap Value portfolios tend to focus on these more value-oriented companies.

ICM's Small-Cap Value strategy generally benefited from strong stock selection within the consumer (staples and discretionary) and technology sectors. Specifically within the technology sector, our investments are focused on companies that compete in market niches and those that can grow regardless of economic trends. Within the consumer sectors, our portfolio is comprised of mostly individual stories—companies that will drive their own success largely independent of macroeconomic trends.

Oil prices remained at record levels during the quarter, which continue to drive energy and oil companies' prices ever higher. Our energy exposure remains fairly light as many of these companies' earnings have yet to catch up to their stock prices. However, we do believe that an opportunity remains within the natural gas producers and selected service companies, due to the limited supply of domestic natural gas and its inherent import difficulties.



Source: Bloomberg

We continue to believe that client portfolios should be underweighted in financial services companies relative to the Russell 2000 Value index. However, during the quarter this restrained performance as financials posted an 8.44 percent gain. Our conviction about the negative outlook for this sector increased during the quarter as the yield curve continued to flatten in the face of Fed tightening (please see chart above) with the spread between the 2 and 10-year Treasury notes at roughly 0.3 percent. We believe that small financials will eventually feel the crunch as borrowing short and lending long becomes progressively less profitable.

## Looking Forward

We believe that it will be a slow summer with minimal market volatility. We are beginning to hear the CNBC pundits speak of a summer rally (especially since both the winter and spring rallies failed to materialize). Unfortunately, when we look back on the historical pattern of summer returns, summer is the weakest rally point of the four seasons. And, without any upside catalysts, we are most likely stuck in a trendless market. Additionally, Wall Street's earnings growth expectations for the S&P 500 are trending lower. As you can see from the table on the following page, corporate earnings growth is slowing as year-over-year earnings comparisons become more difficult.

	S&P 500 Earnings <u>Per Share*</u>	Year-Over-Year <u>Growth</u>
June 30, 2003	\$13.39	5.60%
December 31, 2003	\$15.17	25.68%
June 30, 2004	\$16.66	24.42%
December 31, 2004	\$17.63	16.22%
June 30, 2005*	\$18.23	9.42%
December 31, 2005*	\$18.53	5.10%

*\*Mean earnings estimate of S&P 500 reported earnings.*

Future purchases and near-term performance of our Small-Cap Value strategy will be dependent upon our ability to uncover out-of-favor stocks with good business fundamentals that are temporarily undervalued. We believe that our bottom-up stock picking strategy will work well in this type of environment and we continue to focus on companies that we feel can grow earnings despite tepid macroeconomic conditions. The inefficiencies in the small-cap value sector often result in situations where investors overreact to bad news. We strive to find those situations in which stocks become oversold relative to their fundamentals and intrinsic value. Seasonally, opportunities will present themselves, particularly as we head into the time of year when tax loss selling increases the frequency of such events.

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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.