

SMALL-CAP VALUE COMMENTARY LETTER SECOND QUARTER 2008

“I steer my bark with hope in the head, leaving fear astern. My hopes indeed sometimes fail, but not oftener than the forebodings of the gloomy.” (Thomas Jefferson, 1816)

OVERVIEW

In our previous commentary letter, the market’s recovery at the end of the first quarter provoked us to ask the rhetorical question, “Has the sentiment really shifted, or is this an aberration that in time will reverse itself?” As the second quarter closed, the latter appears to be the case, with the Russell 2000 Value Index giving back the gains it accrued earlier in the quarter.

Clearly, the domestic economy is shaken. The international economies are beginning to slow, albeit still growing at a relatively healthy clip, but higher inflation and uncertainty are definitely beginning to weigh on growth and expectations for growth. It seems noteworthy to us that most of the financial community is still debating whether or not the U.S. is even in a recession. Our guess is that the U.S. is probably entering a recession, and that recovery is likely to be much slower than many would like. That said, for most equity asset classes the bear market is 10 to 12 months old; and most of the equity indices are already down by 20-22%.

Even in light of these uncertainties, investors can not let the media’s often emotional coverage prompt reactions of fear or panic that disrupt a disciplined investment process. We presently find this to be an excellent environment for seeking out undervalued/under-researched companies that will provide good growth opportunities over the next several years. This bear market may last longer, but we are convinced that it is, quite frankly, too late to sell and that too many excellent values already exist not to embrace the positives. In fact, we believe that there are opportunities being created that we have not seen for many years.

The second quarter was filled with conflicting data on the U.S. economy and volatility persisted as it had in the first quarter. Growth outperformed value, as a focus on healthy, predictable companies dominated. Smaller companies outperformed larger companies, which turned out to be counterintuitive to most pundits’ predictions at the beginning of the quarter. Growth and investment continued within the energy markets as oil prices reached new highs. The industrial and infrastructure sectors, focused on international expansion, excelled as well. And as expected, the financial services sector continued to languish.

However, with high oil and food prices persisting, discretionary income continues to be pressured, business spending has begun to slow and the financial services sector has yet to stabilize. This has created a sharp loss in confidence and overall selling pressure within the equity markets. The bear market, in essence, has finally come out of its cave. That’s the bad news. The good news is, we at ICM, have seen this before. In time, this bear market will bottom, and we are using this time to assess which stocks will be the new winners in the rally that will follow this bear.



PORTFOLIO PERFORMANCE

ICM is pleased to report that our Small-Cap Value strategy outperformed the Russell 2000 Value in most client accounts. Again, throughout the quarter our investment thesis did not change. We have been very concerned about the health of the financial services sector and thus have remained significantly underweight that sector. This continued under allocation proved to be very successful in boosting the quarterly returns and we think, in the interim, the turmoil will likely persist. Although we still believe it's early to start buying into this sector, tremendous value opportunities are emerging. We have been spending considerable time evaluating the sector and individual candidates, especially among the banks, and anticipate beginning to invest here in the foreseeable future.

The producer durables and consumer services sectors also provided upside to performance versus the index, primarily due to our security selection. Within these sectors we had a number of investments show improvement in their operations in the face of an uncertain economy. Despite our concern and the concern of most investors regarding the ability of the consumer to continue to spend, our investment thesis continues to focus on unique companies that can show improvement within their own internal operations over time, and that's what we saw occur in the second quarter. In fact, we continue to seek and invest in securities within all the sectors that have healthy balance sheets, good management teams, sell into diverse and international markets, and have unique products that can continue to do well despite the volatility and uncertainty in the markets.

Lastly, because we remain very underweight the financial services sector, we are by default overweight most other sectors, most notably the technology sector. From a valuation and investment perspective, this sector fits all the attributes noted above and in our accompanying Economic and Investment Outlook letter. Most of the technology companies we've invested in have unique products that are selling into niches within growing industries. Their balance sheets are in good shape and valuations are very compelling with significant upside in a less anxious market environment.

LOOKING AHEAD

As we noted in our previous letter, pessimism by both consumers and businesses is causing Americans' confidence in the health of the U.S. economy to deteriorate. This is understandable and to be expected, given the drastic increase in gasoline prices, the decline of house values, and the ongoing crisis in the banking system. However, as we emphasized in the Economic and Investment Outlook letter, the U.S. economy will adapt to these realities in time, the financial markets will stabilize and the confidence will be restored. We firmly believe that is the case, but the difficulty is in not knowing precisely how soon that time will come. In light of the exceptional value that has been created, now is not the time to run for the exit. Rather, we think it's a great time to selectively invest in those companies with the wherewithal to work through these tough times and position themselves to benefit when confidence, stability and growth do come back into the markets.

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.

