

# SMALL-CAP VALUE COMMENTARY LETTER THIRD QUARTER 2005

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

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### **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 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

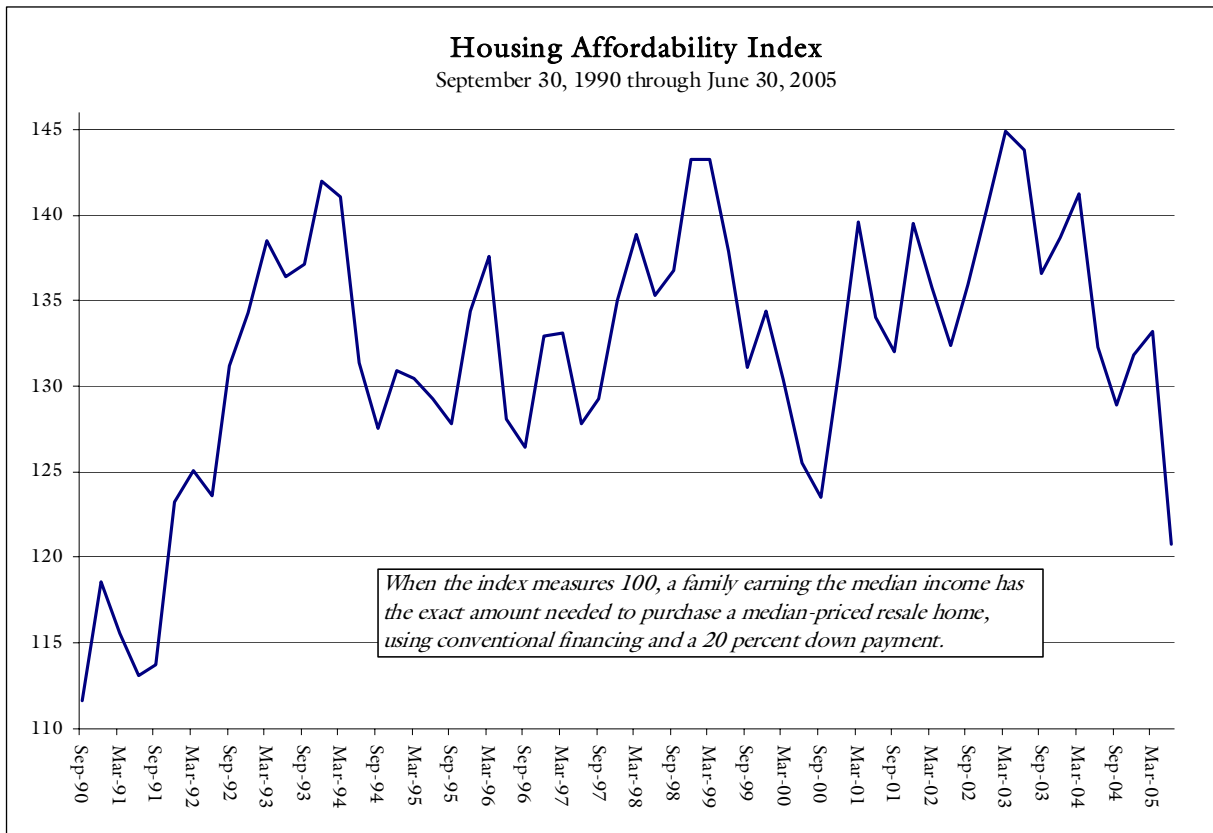
housing market has contributed to 50 percent of economic growth in the first half of 2005, and since the fall of 2001, perhaps 60 percent of new jobs created have been related to the housing boom. Easy access to home equity has also driven consumption at the margin, which has been multiplied by the ability 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.

<b>Annual Cash-Out Percentage For All Prime Conventional Loans</b>			
Freddie Mac Cash-Out Refinance Report Q2 2005			
<b>Year</b>	<b>Cash-Out Dollars as a Percentage of Refinanced Origination Amount</b>	<b>Total Home Equity Cashed Out (\$ billions)</b>	<b>Volume of Cash-Out and Second Mortgages/HELOC Consolidation (\$ billions)</b>
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 over-spent, the consumer health of Japan, Europe, and China look much better (see table below). 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%

Source: Morgan Stanley and 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.

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## **Portfolio Performance**

The small-cap equity market continued the gains made in the prior quarter, despite the specter of continued interest rate hikes and higher energy prices due to the effects of hurricanes Katrina and Rita. The Russell 2000® Index returned 4.69 percent with the growth component outperforming value at 6.32 percent and 3.09 percent, respectively.

ICM's Small-Cap Value portfolios performed well versus the indices this quarter. As would be expected, the best contributors to performance were individual companies within the Energy sector. These companies were driven by the continued strength in oil and natural gas prices, assisted by supply disruptions caused by the hurricanes. We continue to take profits in those companies that have already reflected a best-case scenario for future commodity prices. We also saw strength in select technology companies that are participating in global market expansion or that are producing next-generation technologies to replace those that are obsolete.

As reflected in our economic overview, the Consumer Discretionary sector is starting to experience some selling pressure. Despite the sustained economic growth we have seen for a few quarters, inflation concerns continue to be at the forefront of many conversations. Also, gasoline at \$3 per gallon is clearly acting as a tax on all other consumption. Although our Consumer Discretionary sector weighting reflects otherwise, we are in the camp of questioning the consumer's ability to continue spending significant dollars going forward. Our focus in this sector is finding special-situation companies that are in the process of trying to expand margins through restructuring of operational inefficiencies. In addition, the Russell sector breakdowns classify some of the companies as Consumer Discretionary, where we clearly see them as Consumer Staples or Consumer Business/Technology. Typically during tax-selling season, the market experiences a broad sell off in perceived weakening sectors, regardless of individual company dynamics. These are periods where we find our best individual company buying opportunities.

The Financial Services sector return lagged the index average significantly this quarter, due to weak performance turned in by the bank and thrift stocks, and REITs. We have been underweight the indices for some time, and as a result, the portfolios continue to benefit relative to the indices' performance. As we expected during the quarter, the Fed continued on its path of measured interest rate increases by once again raising the fed funds target rate due to inflation concerns. Over time, these increases will hurt bank earnings. Real estate prices have been increasing at an unsustainable rate, and we believe property value increases are ready to take a breather. Given that banks, thrifts, and REITs comprise about two thirds of the Financial

Services sector, we continue to believe that our clients' portfolios should be underweight in financial services companies relative to the Russell indices.

### Looking Forward . . .

As a result of our decision to be underweight in Financial Services, by default, we are overweight in other areas. Overall market volatility now appears to be accelerating and we see this as an opportunity. Inefficiencies in the small-cap universe often result in situations where investors overreact to bad news. Seasonally, tax-loss selling accelerates this time of year and can provide great prices to buy stocks. Our focus remains on selecting out-of-favor stocks of companies that we feel have potential to generate positive earnings growth and margin recovery, regardless of the economy and sector.

With respect to energy and the consumer: crude oil, natural gas, and gasoline prices continue to act as drags on the market, and we believe it will eventually weigh on the consumer, particularly when the home heating season begins. The belief is that as consumers pay more to fill their tanks and heat their homes, the excess discretionary income they may have had will begin to erode. With that said, we still believe value opportunities are created in companies in the consumer sector, where individual special situations or unique growth opportunities will drive their own success in the future. Overall, with an economy that continues to show signs of strength, paired with uncertainty from rising oil and gas prices, we believe ICM's value investment process and detailed discipline are paramount for successful investing in this environment.

From a defensive perspective, keeping your 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 the market inefficiencies that occur within the small-cap arena. 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 value stock investing, we believe your portfolio is well suited to capitalize on our efforts.

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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.