

SMALL-CAP VALUE 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 Small-Cap Value portfolio.

Portfolio Performance

The small-cap equity market was able to post a minor gain in the quarter, recovering from a sharp sell off in October before rallying into positive territory by quarter end. The Russell 2000® Index returned 1.13 percent, with the growth component outperforming value at 1.61 percent and 0.66 percent, respectively, marking the second quarter in a row that the growth subcomponent of the index beat its value counterpart.

ICM's Small-Cap Value portfolios underperformed the index this quarter; however, they outperformed the index for the year. The bottom-contributing sector was Consumer Discretionary. This portion of the portfolios lagged due to a couple of stock selections, which were also hit by tax selling pressures, especially in October. Their prospects are being re-evaluated and we will decide whether to stay with them after any possible "Santa Claus rally."

The biggest contribution came from the Producer Durables sector, where performance was driven by the individual dynamics of the stocks we held. While we still remain underweight in Financial Services, there too our selections performed significantly better than the index. The Energy sector did a reversal from the previous quarter, going from best to worst performing group in the small-cap universe. Our stocks however, performed in line with the sector.

As we noted above in the economic overview, the consumer weighs heavily on our minds right now. The tailwind provided by extremely low interest rates and the wealth effect of house price appreciation appears to be turning into a headwind, as both of these factors abate and energy costs rise. We expect business spending to be stronger than consumer spending in 2006, as corporations have sufficient cash to fulfill the expectation of a capital spending cycle that has not materialized since the tech-bubble market burst earlier in the decade.

For many years, an important piece of the ICM investment process has been to identify opportunities in broad based sectors that are undervalued versus the overall market. When that undervaluation is combined with a belief on our part that the catalysts are in place to favor an industry, it deserves a heavy weighting; however, we currently do not see any particular sectors that stand out from the crowd. As a result, our current efforts focus on scouring the investment landscape for opportunities with individual companies whose unique situations and valuations make them attractive. Some of the issues that we select are acquired on the expectation of strong unit sales growth, while others are attractive as turnaround candidates, more dependent on their own specific circumstances than the general economy. They all have common features. We consider them cheaply valued and candidates for margin expansion.

Looking Forward . . .

Looking at our exposure, a number of the stocks we hold in the so-called "Consumer Discretionary" category are really leveraged to business spending, but are classified in this sector by industry convention. Still others fit the above descriptions of margin expansion or turnaround contenders. So, we are not as heavily dependant on the consumer as appears to be the case at first blush. This is an important point given our skepticism about future consumer spending.

Turning to the Financial Services sector, we remain underweight versus the index. Real estate stocks comprise one-third of the sector weight, and we believe the country has

seen the peak in property price increases, which should weigh on this group for some time to come. Short-term interest rate increases also appear to be peaking, which should bode well for banks in the future, but small banks face a number of other particular challenges that convince us to stay underweight their industry for now.

The current investment environment of lackluster returns can work well in our favor. Our Small-Cap Value strategy focuses on identifying and exploiting inefficiencies in the small-cap arena. We seek situations where the stocks are undiscovered or have become oversold relative to their improving fundamentals. We also strive to find companies with healthy balance sheets and improving earnings that have not yet been adequately appreciated by the market. When large amounts of money are flowing into small-cap value stocks, it tends to drive the indices more so than individual stories, and the advantage of our selection process can become obscured. Money flows into small value appear to be slowing, which should allow individual stock selection to become more important as a contributor to returns. We remain optimistic that the market will realize modest positive returns in the coming year and that your portfolio is well suited to capitalize on our efforts.

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.