

# SMALL- to MID-CAP VALUE COMMENTARY LETTER FIRST QUARTER 2007

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## Economic Overview

The beginning of 2007's first quarter continued the upward climb from last year's fourth quarter; however, investors saw a significant market sell off at the end of February. Then in March, the market began to rally again. This volatility stemmed from a continued slowing within the residential housing market, sub-prime mortgage concerns, and the short-term unwinding of the Japanese carry trade, catalyzed from rumors of tightening by Chinese authorities. When the dust settled, the market and ICM's Small- to Mid-Cap Value portfolios had mostly recovered by quarter end.

The return of high volatility to the market after many months absence served as a "shot across the bow" to investor complacency, which was the product of a steadily climbing stock market without much in the way of corrections. The risk level to stocks has ratcheted up this year due to a confluence of factors. Front and center is the overriding question of just how much the economy will slow. Is it poised to be bad enough to engender a recession and a full blown bear market? If so, could it be avoided, and will the Federal Reserve be the market's savior (by easing interest rates) or nemesis (by raising them still higher)?

In the last three quarters of 2006, the U.S. economy grew at only about a 2.25% to 2.50% real rate, slightly below what is considered its long-run potential. The outlook for 2007 is likely a bit lower than those rates. The Federal Reserve is forecasting a weak first quarter, followed by an uptick, so that the year's growth would come in slightly below the long-term potential. Most market participants seem to expect the Fed to ease interest rates sometime this year, based on an expectation that the primary risk to the economy is a stall. However, the most recently released minutes of the Fed's Open Market Committee show they were concerned the odds had increased that inflation would fail to moderate as expected and inflation risks remained the Committee's predominant concern. The risk, as ICM sees it, is the Fed may overshoot the target on inflation protection, and in turn, choke the economy into a recession with a tight money policy. Normally, a weakening economy reduces the need to raise interest rates, assuming an increase in inflation does not coincide with slowing GDP (what was termed "stagflation" in the 1970's).

Another reason interest rates may stay elevated is because our federal debt is dependent on demand from foreign countries to buy our bonds. This could force the U.S. to maintain higher rates in order to entice foreigners to continue supporting our deficit spending—this issue is exacerbated by a weak U.S. dollar. The dollar has been trending down in value versus foreign currencies since its last peak in late 2005. The exchange value of the dollar versus the Euro is particularly noteworthy, with the dollar at an all time low when compared to that currency. There has also been talk out of Europe about the possibility of further rate increases in Europe's key bank rate before year end, further complicating the prospects for lower U.S. rates.

We remain in the camp of believers that the economy won't slip into a recession and a big, bad, bear market isn't lurking just around the corner. After all, monetary policy is not (yet) restrictive, valuations seem reasonable, and a healthy wake-up call alerted investors by the market's dip at the end of February. We remain constructive about our ability to make money in the market this year, yet a review of some additional risks is worthwhile to discuss.

Consensus estimates for earnings growth of the major stock indices have been reduced steadily for 2007, to the point where the growth rate is now forecasted to be in the mid-single digit range. This estimation compares poorly to the past few years where we were spoiled by double-digit profit growth; therefore, the average stock won't necessarily benefit from a "rising tide."

The housing market continues to be a headwind for the economy. We expect home prices to trend flat to down over the medium term. The key issue is the slope of the decline in prices. No matter how steep this decline, it constitutes a reduction of the housing benefit to consumer spending, since spending in recent years was materially driven by home equity appreciation and borrowing.

Last quarter we wrote about federal regulators beginning to show signs of demanding tighter lending standards and how this might be a drag on the residential real estate market. This quarter, the chickens came home to roost, as sub-prime mortgage default rates accelerated and unfortunate stories about lax lending practices became regular news. Sub-prime mortgages were a material portion of the total of new mortgages issued during the last few years. Note that only a minority of all sub-prime mortgages will default, but it appears the entire category is being painted with the same broad brush, which potentially will result in a contraction of mortgage credit and thus housing demand. If the "marginal demand" of sub-prime borrowers is removed from the market, a major crimp will be put in the demand side of the housing market. Forced selling by some of those buyers will also temporarily increase the supply overhang.

Offsetting this scenario, we continue to experience historically low unemployment rates in this country. As long as consumers have jobs, we are confident they will spend (and spend and spend). As we've stated before, the consumer side of the ledger represents about 70% of GDP. Job and wage growth then become key factors in maintaining the economy's momentum. How much push we'll get from both of these factors is a big unknown. However, we are encouraged that exports have been growing at a fast rate in recent months, no doubt partly due to the cheaper U.S. dollar.

A final risk to keep an eye on is the state of the credit markets. Debt has become very cheap, especially for the corporate version of sub-prime homeowners (namely high-yield or "junk" bonds). The extra interest rate these borrowers must pay, above what the government pays, is called the spread, and high-yield spreads have compressed, which indicates lenders see the possibility for default from these borrowers as low when compared to historical norms. History shows credit spreads are cyclical. We can envision a time when spreads widen and the availability of corporate credit worsens. This situation would

represent the same kind of dampening effect on the corporate world that the sub-prime mess is having on the residential real estate market.

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## **Investment Selection Process**

Investors always have choices of where to put their money; therefore, we'd like to make it clear why we are still bullish on small- to mid-cap value equities as an overall asset class. Generally speaking, there are three main asset classes investors participate in: bonds, real estate, and equities. Currently, bond yields are low, and a buyer of long-dated bonds is implicitly saying they are willing to accept a historically real yield of two to three percent, plus an inflation risk premium of approximately the same amount. Historically, stocks have provided a greater return than bonds when adjusted for inflation. Also, we believe the odds of inflation exceeding that amount are a meaningful risk, which would present a capital loss potential to the bondholder. Conversely, if bond buyers are expecting capital gains, they are implicitly betting interest rates will head down materially from what are already low levels—an event, which to us, still seems unlikely.

Real estate has been the hot asset class so far this decade, and we believe the odds are it will slow in performance, if for no other reason than returns typically regress to a mean in any asset class. Valuations of income properties have hit historically high levels, with buildings selling at capitalization rates well below 5% in many cases. Given the cost of debt is at least that much and the cost of equity even more, a buyer at these levels will require very significant rent increases just to earn a decent risk-adjusted rate of return. Alternatively, property buyers could, like bond buyers, assume even lower interest rates (and higher property values) in an effort to resell at a profit.

Equities as a group appear to be neither excessively cheap nor expensive, but are within the range of past valuations. We think small- to mid-cap equities continue to provide opportunities for company-specific gains as we look out over the next half decade.

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## **Stock Selection Criteria**

Our value strategy seeks to own stocks of companies that can fare better if a slower growth environment continues to unfold. We see no particularly compelling “single decision” investment strategy, but instead are looking for companies that offer some combination of the following features:

First, we seek companies that can drive sales on a unit growth basis due to their individual company and industry dynamics. For example, this may be a company and/or industry selling into the sweet spot of a product line upgrade cycle. Another example is a company selling into a market niche that is growing fast due to a shift in consumer tastes or economic realities. Note that these types of examples are often easier to quantify for smaller companies than larger ones because we can isolate the decision points to a lesser number of variables.

Secondly, we're also keyed on each company's or industry's pricing outlook and competitive framework. We have more than one company in the portfolios that, although they are smaller-sized companies, are dominating their market niche and are gaining dominant market share, both organically and through acquisitions. Pricing often becomes more attractive when the number of competitors is whittled down over time.

Next, we own numerous companies that derive a preponderance of their revenue from outside the U.S. The world is becoming steadily less dependent on the U.S. for growth than it was in the past and thus, a slowdown in America does not necessarily imply an equivalent slowing in foreign economies. The International Monetary Fund's current *World Economic Outlook* studies this concept in great detail and concludes that past episodes of synchronous economic recession were not the result of the rest of the world following the U.S. when we had a recession, but rather, it was caused by factors that affected many countries simultaneously. They cite the oil price shock of 1974 to 1975 and the bursting of the technology bubble in 2000 as two such examples. Further, if the U.S. slowdown remains moderate, the spillover effect to our trading partners will be considerably smaller than the direct effect would be inside the U.S. Another way of saying this is our economies are only *partially* correlated. Meanwhile, the developing world's economies are expected to grow faster than the United States, so foreign sales exposure can translate into faster sales growth.

These strategic principles do not preclude investment in domestic-based, high confidence, turnaround opportunities. We actually own a number of such companies, which are businesses with unique, compelling, specific factors that can produce earnings growth from achieving their planned improvements that can occur despite any offsetting drag from a slower-growth economy.

And finally, we look for companies whose sales outlooks are not linked to the rate of GDP growth. An example of this is a late economic cycle company that is dependent on state and local government spending for its revenue stream. State and local budgets around the country are looking flush with surpluses and we expect that surplus cash will be spent.

Overall, the country remains in the middle of a slowing economic cycle that will either reaccelerate or dip into recession, with no compelling sector discounts to buy into. This environment calls for selective stock picking and that is something we apply here at ICM.

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## Portfolio Performance

ICM's Small- to-Mid Cap Value portfolios' performance finished the quarter trailing the Russell 2500™ Value and the Russell 2500™ Indices. Early in 2007, many of the portfolios' holdings began to reflect stronger valuations and we trimmed or sold positions as they reached internal price targets. As this new cash became available, we added



many new names to the portfolios after the sell off in February while continuing to increase the weightings of a few existing names. In both instances, the positive information and catalysts we identified that make these companies good value candidates have yet to be acknowledged by the markets, hence some unfavorable perceptions continued to surround these newer holdings. As the year progresses, we believe as more positive news is released, the performance of these newer holdings will begin to rise over time.

It is worth mentioning that financial services was the weakest contributing sector within the indices. Banks and thrifts performed poorly. We attribute this to the continued yield curve inversion, along with perceptions of increased risk to loan losses due to the cresting of real estate values. Surprisingly, REITs continued to defy gravity, trading at lofty valuations. We continue to maintain an underweight exposure to this sector, in acknowledgement of the ongoing risk we see in banks and REITs. As overvaluations unwind, we will look to selectively add undervalued ideas in this part of the market.

Going forward, we maintain our disciplined approach of investing appropriately for your portfolios when we find compelling value candidates.

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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.*

