

## **SMALL-to MID-CAP VALUE COMMENTARY LETTER FIRST QUARTER 2008**

---

### **PORTFOLIO PERFORMANCE**

Generally speaking, equity markets around the world performed negatively for the first quarter of 2008. Domestic equities from Small-Cap to Large-Cap were not spared in the sell off, nor were value or growth strategies. Why? Concerns over the health of the U.S. economy and the unraveling of the U.S. credit markets continue to persist and cast a darkening cloud over the confidence among consumers and businesses. Questions about rising costs impacting discretionary spending and whether the U.S. economy will indeed sag into a recession are the conversational centerpieces on the evening news. These questions, coupled with falling home prices and slowly rising unemployment rates, are causing a great many people and business leaders to simply batten down the hatches and hunker down until the storm passes. As we will discuss in more detail in the subsequent paragraphs, it is our opinion that some of these asset price moves are substantially overdone, creating both new risks and, equally important, compelling new opportunities.

To address the future, we must first address the past. Performance in the Small-to Mid-Cap Value strategy slightly trailed the Russell 2500™ Index and lagged the Russell 2500™ Value Index. The primary underperformance versus the Russell 2500 Value Index occurred within the first month of the year; a time frame where uncertainty and pessimism appeared to be at their highest in the quarter and extreme volatility rumbled the markets almost daily. March brought with it the belief that monetary policy and the collective actions over the previous months by the Federal Reserve were going to see the U.S. economy through these trying times, but the Fed still had to deal with issues such as what occurred with Bear Stearns. Lastly, an investment shift appears to have begun to unfold with value outperforming growth during the first quarter and stability may be working its way back into the investment psyche. Has the sentiment really shifted, or is this an aberration that in time will reverse itself?

Our sector strategy has not wavered through these troubled times. We were underweight in the financial services sector all of last year; we were again underweight in the first quarter, and will continue to be underweight looking into the near future. This sector was down another 5.97% in the Russell 2500 Value Index this quarter, and we believe it will continue to suffer until the excesses work through the system. Currently, we have one investment in a well-capitalized insurance company that we believe will weather this storm and is positioned for strong growth in the years to come. As time and selling have lowered values and caused Price to Earnings compression within this sector, we are aware that the



dust will eventually settle and good value will be had, similarly to the aforementioned insurer. However, we remain on the sidelines, sifting through the wreckage, assessing who the winners and losers will be and who will stand tall in the end.

Turning to the consumer discretionary sector, we have understood for some time now that as the domestic economy slowed and oil, gas, and food prices continued to climb, spending shifts were bound to occur. As in the fourth quarter, the first quarter was a continuation of that spending shift, particularly within the lower to middle income areas as their focus was on items that they needed and not just desired. Despite this headwind, in the first quarter we had notable success with one company in particular that provides rental related services among home and entertainment products. This company had traded well below book value in the past few months despite having an excellent balance sheet and prospects for operational improvements and earnings growth. While we are exposed to this sector, the portfolios' exposure to direct consumer spending is less than it appears, and the investments that have been made are, in our opinion, valued very inexpensively. Much of our exposure in this sector is actually to business services companies. As with financials, good value will be found within those companies directly impacted by consumer spending, but our belief is that only limited opportunities will occur in the near term and it will be on a company by company stock selection basis. The utilities sector within the portfolio assisted performance, relative to the index, in the quarter and we believe it will continue to do so in the near to intermediate term. This sector has served dual purposes: We hold undervalued companies with very good prospects for earnings and dividend growth. These companies are also less volatile and provide a bit of a cushion versus the wild equity market swings we have seen over the past year.

Laggards in the quarter came primarily from the producer durable and materials and processing areas. Detractors in these sectors can be categorized as having some exposure to escalating energy costs, fears of commercial construction slowing similar to residential construction in 2007, or a few technology companies that, along with the decline in the NASDAQ Index of roughly 14%, continued to be sold off indiscriminate of their bright prospects in the year ahead. In most of those cases, where they were initiated in the past six to nine months, we have increased our weighting. In other cases, we continue to monitor progress and look for entry points to increase respective weightings as operational improvement becomes more tangible.

Where does that leave the portfolios positioned today and for the future? We believe in companies that have good products, service, and management, with minimal or no debt and ample cash to withstand economic shocks. Also, where possible, we have emphasized companies with significant revenue generation from international markets, particularly emerging markets, where future growth has yet to be influenced by the U.S. economy and the struggling economies of other developed nations. We also believe that portfolio



performance will come predominantly from the collective result of timely individual stock by stock selection, as uncertainty regarding a slowdown and possible recession infiltrates all areas of the economy. We believe certain technology, producer durables and materials and processing companies are in unique and or niche areas where a combination of great value and good revenue growth potential lies. A good example is a data storage company who has announced and begun production on a contract with a major tier one supplier of computer and related equipment. Operating expenses will be a bit high in the near term, but the prospect for revenue and ultimately earnings increases is very high over the next twelve months. Another example is an energy services company that provides diving and related activities to meet the growing energy demand within U.S. and international waters. The company has significant market share and a history of excellent operating performance. We expect them to drive revenue growth and earnings growth as demand for their services accelerates in the coming months, driven by still higher prices for oil and natural gas. We also believe these, and many other investments, will perform relatively well in these uncertain times, and will be extraordinary investments as the economy recovers.

Finally, although pessimism and lack of confidence by both consumers and businesses are causing some Americans to stick their head in the sand, it is our opinion that some of these asset price moves are substantially overdone and many small equities are at more extraordinary values than we have seen in years. Many of the companies we have been talking about for the past six months are beginning to regain their momentum and show progress in their operating performance.

Are we out of the storm yet? Not likely, but as long as the U.S. economy can ride out this 'perfect storm' created by excesses in the credit markets and emerging economies continue their path of growth, the sun will break through the dark clouds and the investments we have made will begin to return to more normalized valuations.

---

*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.*

