# ICON PORTFOLIO UPDATE

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It has been a frustrating year for equity value investors because of the disconnect we've observed between company and investment fundamentals and investor behavior. Earnings per share (EPS) for the companies in the S&P 500 grew 15% in the third quarter of 2011 compared to that period in 2010. And as 2011 draws to a close, EPS are estimated to grow more than 12% over the course of the year. Declining interest rates, another fundamental that is usually positive for stocks, should have provided support for higher equity valuations. But investors did not embrace these fundamentals and instead focused on worries surrounding the slowing U.S. economy, China's slowing economy, the European sovereign debt crisis and the federal government's bitter in-fighting over the deficit. We feel, however, that each of these issues is in the process of being resolved favorably.

Until the second quarter of 2011, the U.S. economy was posting gains typical of recession recoveries, but instead of progressing from recovery to expansion, real GDP grew at a dismal 0.4% annual pace last spring. With modest improvement during the last two quarters, and recent better-than-expected economic data, the slowdown now appears to be a temporary setback.

In 2011, government officials in China announced their intention to slow China's domestic inflation rate, which meant slowing their economy. Investors feared China might go too far, creating a slowdown that would lead to a recession. The annualized pace of China's GDP has slowed from 11.9% in the first quarter of 2010 to 9.4% in the third quarter of 2011 and inflation has come down. We do not know if the Chinese are done tightening their fiscal policy, but do feel the worst is behind us. A 9.4% GDP for an economy as large as China's is adequate to contribute to overall global prosperity. Unlike in the U.S., where we attempt to "influence" our economy with fiscal and monetary policies, Chinese officials arguably "control" their economy. We therefore expect them to be able to reduce inflation without causing a recession.

We see progress on the European sovereign debt problem. Governments, commercial bankers, and central bankers have all acknowledged the debt crisis and are working to resolve it. Naturally the political posturing associated with that work—posturing which often includes unreasonable demands, nonsensical refusals, and other obstinate behaviors— is upsetting to investors. Along the way we anticipate there will have to be compromises. We would not be surprised to see things like austerity programs, inter-government guarantees, easing Euro monetary policy, and banks raising capital on unfavorable terms and/or being absorbed to protect depositors. While these compromises may be difficult, they are all doable and necessary.

We expect stock prices will ultimately respond to valuations and fundamentals and break loose from the anxieties that made 2011 so frustrating. We believe the rally in October, when a resolution to the European situation appeared at hand, gives us a clue as to what any upward move will look like. Generally the cyclical, economically sensitive sectors led the October 2011 rally. We expect more of the same if fundamentals take over and temporary concerns subside.

## INTERNATIONAL EQUITIES

The situation for international equities is similar to the situation for domestic equities. Fundamentals and valuations at the company level appear attractive, but investors seem to be focused on most of the same concerns; the U.S. economy, China's economy, and the European debt problems. With these economic concerns driving prices, the cyclical, economically sensitive industries have been hit the hardest on downturns and therefore, in our estimation, represent the best bargains. We anticipate a greater resolution of the economic concerns now plaguing the United States, China, and Europe in 2012. Subsequently, we expect stock prices will ultimately respond to fundamentals and value, with the Industrials, Materials, and Energy sectors leading the way.

## BONDS

Thirty years ago, on September 30, 1981, the yield on the 10-year Treasury bond hit a high of 15.842%. This year it reached a low yield on September 22 of 1.719%. As of December 19, it was still below 2%, at just 1.81%. We think disinflation (reduction in the rate of inflation), combined with a growing realization on the part of investors that the high inflation of the 1970s was not returning any time soon, contributed to the decline in yields. A current yield below 2% seems quite low to us, not only relative to the lofty 15% of 1981, but relative to other investment opportunities in the market today. We favor corporate bonds and do not believe that a fixed yield in the 2% range will be adequate for investors.

## SUMMARY

Value investing does not require inside knowledge or an ability to forecast events. It requires discipline, patience, and the confidence to go against popular consensus at times. Over the long run we believe value investing can be a very productive strategy, but there are times when value investors do not get rewarded for holding stocks they believe to be cheap. Over the last 8 months, stock prices have not been driven by intrinsic value, but by investors reacting to current events, with many individuals affected by the market decline. We expect domestic and international economic concerns to abate in 2012. As investors grow more assured, we think stocks prices will respond to fundamentals and value.

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*The 10-year yield is the benchmark 10-year yield to maturity reflected by the current issue 10 year U.S. Treasury note. 10-year Treasury notes are debt obligations issued by the U.S. Treasury that have a term of more than one year but not more than 10 years.*

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