

# Portfolio Update

## April 2005

### ■ Domestic Market Commentary

With ICON's system of managing money, it is important to differentiate value and price. Value is what investors would pay if they had full, accurate information and were behaving rationally. Think of it as the true worth of a company. We consider value to be a function of what a company typically earns, the growth rate of future earnings, risk, and interest rates (opportunity cost). Price is determined daily by investors in the marketplace and is a function of emotions, short-term supply and demand imbalances, reactions to news events, and predictions about the future.

Over the long run, we believe price is about equal to value, but over the short run, price and value can diverge quite dramatically. For the first quarter of 2005, fair value for most companies has grown, based on our methodology. The interest rate we use in the ICON valuation equation, the AAA bond yield (as measured by the Moody's AAA Bond Index), is about where it ended 2004, in the 5.45% range. Earnings for 2005 that we use in the valuation equation are generally higher than those of previous years. With risk and the outlook for growth fairly constant, value has grown this quarter. Prices, however, have had a volatile ride, as investors have been concerned about various events. Most U.S. equity indexes finished the quarter slightly negative.

### *Current Market Valuation*

The value/price ratio for the 1,800 domestic equities in our database was 1.14 as of March 31, 2005. That means that prices, on average, for those 1,800 stocks are about 14% below our estimate of intrinsic value. That discount seems accurate given the various events that have caused concern among investors. Iraq, government budget deficits, and oil prices lead the list of events, but we think many investors have reacted incorrectly to such stimuli. Playing amateur economists, some investors incorrectly behave as though there is a clear one-to-one cause and effect relationship between one of those situations and the economy. We disagree and think investors are overreacting to events.

In time, we expect a window when prices catch up to value. The exact beginning of a rally cannot be predicted; in fact, there is usually not an event that ignites a rally. With the ICON system, we hold stocks that have value greater than price, ride through times of value/price divergence, and wait for the rewards that eventually follow.

### *Industry Reallocations*

There have been a few industry switches in the ICON Portfolios this quarter. Some of them have been driven by a few of the cyclical leaders getting too expensive and reaching our sell threshold based on valuation. Others, in the Information Technology sector for example, have been sold based on relative strength, as they do not appear to be part of the potential market leadership. Weightings have been increased in Healthcare and Telecommunication & Utilities sectors. Although these sectors sometimes have a defensive connotation, that is not our intent with the positions. They have the qualities we like as being possible market leaders with potential upside.

### ■ Bond Market Commentary

The Federal Reserve is performing tighter monetary policy by draining reserves from the banking system. Their goal is to slow the growth of the money supply. By draining reserves, they immediately impact short-term interest rates, but not long-term rates. Long-term rates are influenced by investors' outlook for inflation, borrowing opportunities, and many other variables. From September 30, 2004 through March 31, 2005, the yield on the six-month

Treasury bill increased almost 60% from 2% to 3.1%. Over that same period, the yield on the 10-year note has increased only about 10% from 4.1% to 4.5%. The yield on the 30-year government bond has held about even.

Our valuation readings suggest investors are worried about the future of all fixed-income instruments, at all maturities. We are finding bonds priced below our estimate of intrinsic value at all maturities. There also seems to be deterioration in confidence; better bargains exist as we go further away from government issues and more toward corporate and even high-yield bonds. These valuation readings suggest to us that bond investors have overreacted to tighter monetary policy.

#### ■ International Market Commentary

Many international markets are outperforming the U.S. market year-to-date and are showing modestly positive returns. This is a stock performance differential and not a currency-driven advantage. Unlike in 2004, the U.S. dollar has gained slightly against the euro, pound and yen during the first quarter of 2005. The international moves seem sensible based on valuation, as there were many attractive situations entering 2005. Just like in the U.S., there remains a value/price divergence. Jitters among investors appear to be global in nature.

#### ■ Summary

The most legitimate concern for investors appears to be the monetary policy tightening by the Federal Reserve. Investors are left to guess how far it will go and what the ultimate objective is. So far, to us, policy appears moderate and a reversal of the previous easy, accommodative policy to neutral. We are not investing, however, based on guesses regarding Federal Reserve policy. There are plenty of industries with stock prices below our estimate of intrinsic value. As they appear to have the potential to lead the market higher, we are holding them with patience while value and price temporarily diverge.

Yours truly,



Craig T. Callahan, DBA  
President

**Past performance does not guarantee future results.** Investment return and principal value will fluctuate, so that an investor's shares, when redeemed, may be worth more or less than their original cost. Opinions and forecasts regarding sectors, industries and themes and portfolio holdings and composition are all subject to change at any time, based on market and other conditions, and should not be construed as a recommendation of any specific security.

The Moody's AAA Bond Index is an unweighted average derived from pricing data of nearly 100 U.S. corporate bonds with maturities as close to 30 years as possible. All yields are yield-to-maturity calculated on a semiannual basis. The Portfolios' composition may differ significantly from the index. Individuals cannot invest directly in an index

An investment concentrated in sectors and industries may involve greater risk and volatility than a more diversified investment, and the technology sector has been among the most volatile sectors in the market. Investments in foreign securities may entail unique risks, including political, market and currency risks. Investing in fixed income securities such as bonds involves interest rate risk. When interest rates rise, the value of fixed income securities generally decreases. High-yield bonds involve a greater risk of default and price volatility than U.S. Government and other high-quality bonds.

ICON's Value/Price ratio is a ratio of the intrinsic value, as calculated using ICON's valuation methodology, of a broad range of U.S. equities within ICON's system as compared to the current market price of those equities.

Please contact us in writing if you would like to receive, at no charge, the most recent copy of ICON's disclosure document, Form ADV, Part II.

Data Source: Bloomberg © 2005 ICON Advisers, Inc.