

Portfolio Update

April 2004

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Domestic Market

The rally in stock prices over the last year was interrupted in mid-March as stock prices generally declined. While there were a few concerns, one theory was particularly prevalent among investors and the media: the unemployment rate. Although unemployment is near its historical average, many analysts have been disappointed with the rate of gain in jobs and employment. Many investors sold stocks based on the belief that sluggish job growth would cause a slowdown in consumer spending. While intuitively that theory may seem logical, there has been no economic statistical data to give it any credibility.

I examined various measures of consumer spending, such as spending on non-durables, going back to the 1960s. There was no historical evidence of a one-on-one direct causal relationship between employment and these measures of consumer spending. There was no evidence that changes in employment ever caused changes in consumer spending. Interestingly enough, spending on consumer non-durables usually led employment at turning points in the economy. In other words, if a relationship can be proven with this data, spending has caused employment, not the other way around. Any investor who sold stocks based on the belief that sluggish employment gains would cause a slowdown in consumer spending was guilty of faulty reasoning.

This false interpretation happens frequently in the market. Investors act in a way that feels right and may be based on a line of reasoning that has intuitive appeal, but is not based on factual reality. From our perspective as a value investor, we identify those situations as prices diverging from intrinsic value.

Given the recent market dip, our value-to-price ratio for the stocks in our database is 1.22. That means we think stocks, on average, are about 22% below our estimate of fair value. We remain extremely bullish and believe that stock prices are positioned to resume their path back upward to fair value. Naturally, as seen last month, that path can be interrupted by news events and concerns. With our valuation model indicating that stocks are at a significant discount to fair value, we think it is worth tolerating the turbulence and occasional setbacks to get to our ultimate goal.

Not only has the upward path been interrupted the last couple of months, but also has the industry and sector leadership. Other than the upward move in energy industries, the recent market has been theme-less. From March 2003 through January 2004, the industries that are economically sensitive and cyclical led the market including the technology, consumer discretionary, industrials, and materials sectors. We expect that leadership to resume. If there is data to the contrary, we will rotate to a new theme, but as of now, we do not expect that to be the case.

During the down days lately, there has been a complete theme reversal. Investors were jittery about the economy and potential slowdown in consumer spending. The cyclical and economically sensitive industries that led the market last year became vulnerable to selling. Defensive and less economically sensitive sectors such as healthcare, utilities, and consumer staples showed strength. We think this was temporary.

There was one allocation shift during the month. Exposure to the industrials sector was reduced as part of a fairly minor industry replacement and financials was increased. In addition to adding to consumer finance, insurance and thrifts were purchased. It still seems best to favor the cyclical,

consumer, and industrial-related industries and ride through temporary theme reversals whenever investors get jittery about the economic situation.

Bonds

The consensus view and strong belief among most investors that interest rates were going to rise has been incorrect the last nine months. We have been rewarded by positions in long-term bonds as rates have declined. The 10-year Government bond at its high was yielding 4.6% last August and is yielding 3.84% lately. Investors were so convinced that rates were going higher that they preferred to own short-term bonds. During the second half of 2003, those bonds appeared overpriced relative to our measure of intrinsic value. Investors' preference for short-term bonds left long-term bonds on sale. We simply followed our value mandate and were rewarded. As those valuation conditions continue today, we remain content with the mid- to longer-range maturities. So far, the powerful 20-year trend toward lower interest rates remains intact. We believe that factors that contributed to it are still in place.

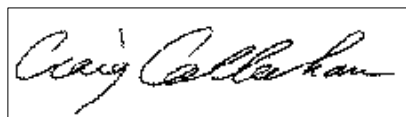
International Markets

Most country markets were highly correlated in March, dipping just like the U.S. market, except for Japan. It simply paused and then headed higher. We added exposure to Japan during March. Exposure to Canada was added during the first quarter. Valuation readings from that country agree with those in the U.S. in finding stocks in the materials sector to be attractive. Stocks in that sector are readily available in the Canadian market.

Summary

There are many situations and lines of reasoning that make intuitive sense to investors but are not based on factual historic economic relationships. The concern that sluggish job growth would cause a slowdown in consumer spending is one recent example. We favor identifying potential leading industries through valuation and then riding that theme through occasional short-lived theme reversals. It is normal for news events to distract investors and interrupt the market leadership. Our valuation data suggests that market action in mid-March was just a temporary setback.

Yours truly,



Craig T. Callahan, DBA
President and Chief Investment Officer

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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.

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