

Portfolio Update

August 2006

Domestic Market Commentary

Over the last two months stock prices have moved, we believe, in response to guesses investors are making regarding Federal Reserve Board (Fed) monetary policy. During that time, when news is announced that shows the economy to be very healthy or shows any type of upward pressure on consumer or industrial prices, stock prices drop. We in the industry assume that investors are judging from that economic strength that the Fed is likely to continue to pursue tighter monetary policy. On the other hand, when news reveals a slowing economy or lack of upward pressure on consumer or industrial prices, stock prices rally. In other words, investors are guessing that the Fed will soon retreat from its tightening mode. In addition to the reaction to daily news events, there is also debate and speculation as to whether the Fed has **already** tightened too much, to the point of stalling economic growth. That is a lot of guessing!

Current Economic Conditions

This recent round of tighter monetary policy began in the spring of 2004, when the Fed started draining reserves from the banking system. At first, short-term interest rates, like Federal Funds and Treasury Bills, rose but longer term rates did not participate in the ascent. Finally, in late 2005 and early 2006, the yield on the 10-Year Government Bond broke upward out of the trading range it had been in between approximately 4% and 4.5%. Since that move, the yield has been slightly above 5%. By draining reserves from the system, the Fed has been successful at slowing the growth of the money supply. M1, which includes currency and demand deposits, was reported to be \$1.3529 trillion for the week of July 17. That is 0.3% lower than a year ago and is down 1.2% from six months earlier. M1 is down 5.0% from its high, April 3, 2005. Slowing the growth of M1 will slow the economy, but that, in our opinion, is the Fed's objective.

What is a good pace for economic growth? From the low point in the 3rd quarter of 2001, when a recession was measured, Gross Domestic Product (GDP) has grown each quarter at an average annualized pace of 3.1%. By our estimation, that rate is about perfect. During most of that time the Consumer Price Index (CPI) rose at an annual pace of about 2.5% to 3%. The scrutiny and guessing regarding the Fed increased after the 1st quarter 2006 when GDP growth was at an annualized pace of 5.6%, well above desirable levels. Add in the fact that there have been five monthly CPI reports above the .5% level in the last year, and many investors are worried that the Fed will tighten much more to slow the economy and keep inflation in check. Providing some relief to those fears was a quite modest increase in the June, 2006 CPI of only .2% and 2nd quarter GDP growth at only a 2.4% annualized pace. We believe both of those readings are very moderate and not indicative that more major Fed tightening is necessary.

ICON's Stance

So what does this mean for stocks and bonds? There have been times in the past when the Fed tightened and stock prices experienced a severe or prolonged decline. Preceding those declines, stocks appeared over-priced relative to ICON's estimate of intrinsic value. There have also been times when the Fed tightened, and stock prices simply experienced a volatile sideways trading range. While stock prices bounced up and down, they did not experience a bear (sharp downward) market because they were not over-priced relative to intrinsic value preceding the tightening. In other words, stock prices did not need to drop because they were not over-priced. We believe that is the current situation. Stocks are not, and have not recently been over-priced, on average, relative to the ICON estimate of intrinsic value. We do not expect a bear market, but instead a trading range while investors fluctuate on their guesses regarding monetary policy.

We see some unusual activity during this turbulence compared to the last few years. When the market would stall out and enter a sideways pattern in 2004 and 2005 there was some common behavior. On dips, the cyclical, industrial stocks would experience dramatic declines. Then on brief upward moves, those same industries and sectors would excel and lead the rise. It made it easy for us to expect that the cyclical, industrial industries with attractive Value/Price (V/P) ratios would lead the market once it broke out to the upside. The last few months, however, have been very different. Each brief up move and down move appear different. Sometimes technology surges higher, sometimes it does not. Sometimes health care industries show life, other times they do not.

Given this turbulence and rapidly changing "mini-themes", our investment model cannot predict what theme and leadership will emerge. This volatility amid rapid daily and weekly industry rotation is typical of a major theme change. We expect new leadership to come out of this and will rely upon our V/P and relative strength readings to spot potential industry leaders.

Why are we riding through this? When the Fed is finished tightening, based on historic experience and our V/P ratio, we expect a rally. Like most rallies it will probably begin suddenly with no warning or obvious invitation. As long as we measure stock prices to be below our estimate of intrinsic value, we are committed to owning them. Based on experience in past similar market conditions, we expect the potential industry leadership situation to become more clear as time goes on. V/P and relative strength will draw us to our favorites.

Bond Market Commentary

We are seeing some encouraging signs in the bond market, but it still appears premature to rush out to long-term maturities. If the Fed succeeds in squelching inflationary pressures through its tightening, we believe it will set the stage for a good bond market. As that has yet to be seen and valuation conditions are not quite right for aggressive buying of long-term bonds, we are staying in short- and mid-range maturities.

International Market Commentary

The market conditions described domestically apply globally. It appears the world is fixated on our Fed and its future policy stance. Global markets are also experiencing rapid industry rotation on various upward and downward movements. We are riding through those moves eager to identify industry leadership on the potential breakout.

Summary

We are riding through the turbulence primarily because we believe stocks have a "value cushion." We do not see them as over-priced, so we think a big drop to the downside is unlikely. In addition, there is not that much for the Fed to cure. The economy is growing a little faster than normal, but is not out-of-control. Inflation has inched up a little as some industries have passed on one-time energy price increases. It is not the double-digit inflation of the late '70s. Inflation is just slightly above target. Therefore, we believe it should not take extreme tightening to reach desired levels.

Prepared by ICON's Investment Committee.

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There are risks associated with small- and mid-cap investing such as less liquidity, limited product lines, and small market share. 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 higher-quality bonds.

To analyze intrinsic value, the ICON valuation methodology relies on the integrity of publicly released financial statements. 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. ICON's relative strength ratio is a ratio of the performance for the preceding six months of a group of equities within ICON's universe as compared to the preceding six-month performance of the broad market.

Gross Domestic Product (GDP), also known as Gross National Product (GNP), is the total value of goods and services produced in the national economy in a given year. It is the primary indicator of economic growth.

The Consumer Price Index (CPI) is the primary indicator of U.S. inflation and is used to make cost-of-living adjustments to billions of dollars in benefit payments. Individuals cannot invest directly in an index.

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