

# Portfolio Update

## December 2005

### ■ Domestic Market Commentary

After an unpleasant and sharp dip in early October, the stock market resumed its broad advance which began in late April 2005. Characteristic of many dips during the last couple of years, fears of deteriorating economic scenarios sent prices lower in October. As investors realized those potential scenarios were more imaginary than real, prices rebounded in their upward move toward fair and intrinsic value.

Early in 2005, I created a presentation to be used at various financial adviser conferences. It made the case that the economy is fine and healthy, but that investors thought otherwise. It communicated that corporate earnings were experiencing impressive growth, but that investors were not acknowledging that growth. In summary, it made the case that, at the company level, valuations have grown in the last few years, but that investors were frequently distracted with events and news regarding terrorism and oil prices. Stock prices would, therefore, experience volatility and frequently lag fair value. Then, prices would spurt to catch up when investors realized that previous fears and doubts were unfounded. The presentation concluded by recommending the strategy of riding through the volatility and dips, as long as stock prices were below our estimate of fair value, so that investors would be able to participate in the unpredictable spurts.

This market move from mid-October through November supports that strategy. Stock prices have generally spurted higher as the fears of October have subsided. Some analysts are trying to guess the sustainability of this rally based on technical indicators such as volume and breadth. We do not make such guesses. We calculate a value/price ratio of 1.15 for the broad equity market. We expect prices to continue moving higher in their attempt to reach our determination of fair value. Naturally, certain random news events could interrupt that climb. The basis for our optimism starts at the company level. Our analysis shows many healthy, growing, well-managed companies. Our analysis shows that their intrinsic values are growing, unaffected by oil prices, the military involvement in Iraq, or hurricanes. We own those companies in the belief that over the long run, price will track with value, although frequently side-tracked by news events.

The industry and sector leadership has changed slightly since the October 13, 2005 market low. Going back to 2001, the leadership during market advances has been in industries that are cyclical, meaning their businesses are sensitive to the economy. Banks and the Financial sector, in general, have not been part of that leadership. Since October 13, however, Financials, including banks, asset managers and investment banking/brokerage within that sector, have led the market. Also among the leading sectors is Materials, with steel standing out as a leading industry within that sector. Energy as a sector is not part of the leadership the last six weeks. Stock prices in the Energy sector had advanced, just at a rate, on average, below the broad market. Based on our valuation, the leadership makes sense. The leading industries offer good value and in our opinion, have further to go on the upside.

### ■ Bond Commentary

The yield on the 10-year Government Bond hit a recent high of 4.661% on November 4, 2005 but has dropped to 4.406% as of November 28, 2005. At that high, investors envisioned a very unpleasant scenario of rising oil prices, increasing inflation, and tighter Federal Reserve monetary policy. The yield of 4.661% reflected a worst-case outlook. The recent decline reflects a softening of those views. Evidence has emerged suggesting that inflation is still very moderate and in check. We do not fear higher rates at this point, but it is too early to tell

whether we are in the early stages of a bond rally.

### ■ International Market Commentary

Most international markets have participated in the advance off the mid-October lows. Just like in the U.S., the dip in October was an interruption to a broad advance that began late last April. The sector and industry leadership is quite similar, suggesting a common global theme. Financials, such as banks, have led the last six weeks. Also as in the U.S., Materials is a leading sector. The precious metals, diversified chemicals, gold and diversified mining & metals industries are leading that sector.

It appears that equities worldwide are participating in a common global rally, but our system is finding better bargains outside the U.S. Our average value/price ratio for all international stocks (ex-U.S.) is 1.32. Of course, there are certain risks associated with international investing, but our valuation suggests there is compensation for those risks. Over the last few months, we have increased the international equity exposure in our Frontier Portfolios based on valuation and strength. This exposure also offers diversification benefits to complement our U.S. positions.

### ■ Summary

With one month remaining in 2005, this year in the markets is looking a lot like 2004. In both years, there were events that distracted investors and caused them to doubt the economic future. During those times, stock prices wobbled and dipped. Then, concerns and doubts faded and were proven to be excessive in hindsight. While it makes for an unpleasant ride sometimes, we still favor owning equities in this setting. Based on our determination of valuation, we think the potential rewards justify this position.

Prepared by ICON's Investment Committee.

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*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.*

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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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*Index Data Source: Bloomberg and FactSet Research Systems*

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