

# Portfolio Update

February 2004

“ICON. Powered by a Disciplined Investment System.”

## Domestic Market Commentary

The market advance of 2003 continued into early January 2004 but faltered the last few days of the month. As the conditions typical of market peaks have been absent, the slight dip appears temporary to our system. While market bottoms and great buying opportunities are usually characterized by fear, negative sentiment, and stocks priced far below intrinsic value, peaks are just the opposite. Optimism, confidence, and overpricing typically prevail at peaks.

Regarding valuation, the ICON value/price ratio for the approximately 1,700 stocks in our database is 1.12. It suggests to us that stocks, on average, are still about 12% below intrinsic value. Our mandate, being value-driven, is to hold stocks priced below our estimate of intrinsic value. At market peaks, featuring investor confidence and optimism, investors are typically eager to pay more than intrinsic value. A market V/P reading of 0.90 or 0.85 might be indicative of excessive optimism and confidence.

There are many other signs to me that investor sentiment has not reached levels that usually accompany market peaks. The questions I still get from the media and at conferences convey a tone of skepticism and doubt. The skeptics seem to want and require a perfect setting or they cannot see the upside potential in equities. They want declining interest rates, rapidly growing corporate sales and earnings, a balanced Government budget and endless steadily growing consumer and industrial spending to be drawn into the market.

The interest rate concern is interesting. There appears to be a consensus among market observers that interest rates must rise in the future. They fear it will be bad for stocks. First, we do not agree with the assumption of rising interest rates. Second, long-term rates are more important to our system relative to stock prices. Even if

short-term rates rise, it is possible for long-term rates to remain low or drift even lower. They have been in a secular decline for 20 years. We do not see any force on the horizon powerful enough to reverse that trend. Third, the affect of an increase in long-term rates is not predictable. If they suddenly shot higher in today's economic and earnings setting, it would probably be bad for stock prices. But, if they rise many months from now, the reaction may be different because the news and economic setting may be different. I have seen rates rise prior to some market peaks, but the earnings and economic news was so good at the time that investors ignored the rising rates. So, it seems counterproductive to worry about potential rising rates at this point.

Some observers have avoided stocks because they do not like the quality of corporate earnings. Earnings for most companies have grown steadily from the lows of the recession in 2001, yet some analysts are not impressed. They believe the growth is due to expense control rather than robust sales growth. Who cares? Earnings are earnings, plus there are many companies with robust sales growth. Those skeptics have missed an opportunity by demanding a 1990s-type setting.

Finally, other doubters worry that economic growth has been driven by consumer spending and that consumers may slow their spending pattern. It seems useless to worry about something that has not happened yet, especially when there is no indication of a severe drop in consumer spending.

In summary, we prefer to be driven by valuation and avoid scenario guessing. The perfect setting being demanded by some observers rarely occurs. Until we see valuation readings typical of market peaks, we will remain invested.

### **Bond Commentary**

Our bond valuation readings are very clear. Investors appear afraid to own long-term bonds. As a result, they are priced below our estimate of intrinsic value. At the other end, investors are clinging to short-term bonds and willing to pay a premium over our estimate of intrinsic value for the comfort of that position. Such dramatic "herd" behavior looks incorrect to us. Sticking to our valuation mandate, we have tilted our fixed-income holdings toward the long-term end of the maturity spectrum.

### **International Market Commentary**

The high correlation among overseas markets has continued into 2004. Most country market indexes have performed similar to the U.S. They advanced in early January and declined the last few days of the month. Markets are highly correlated because the global rally of 2003 had a common industry and sector theme. Regardless of country of origin, technology, consumer and industrial issues led the move higher. We still think that theme is intact, despite occasional interruptions.

### **Summary**

Valuation is not static. It is dynamic and changes through time because the components contributing to value change. All else equal, the value of a company will increase if earnings grow. It is possible to buy a stock at \$30 with an intrinsic value of \$50. By the time the price appreciates to \$50, intrinsic value may have increased to \$60 if new growing earnings have been announced. That is why we do not set sell price targets ahead of time. We do not have to predict the future, just recognize overpricing if and when it occurs. We then behave according to our sell discipline. Currently, there are only a few industries with V/P ratios below 1.00. We believe the industries we own have further to go as the stocks in those industries are still priced below our estimate of fair value.

We hope our name change to ICON Advisers has been well-received. The feedback we have received on it has been very positive.

Yours truly,

Craig T. Callahan  
Chief Investment Officer

**Past performance does not guarantee future results.** 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.

Management of the Portfolios involves sector allocation overlays using sector mutual funds and other specialty funds as the investment vehicle. There are risks associated with mutual fund investing, including the risk of loss of principal. Investing in these funds involves certain risks such as the risk that the funds' performance may be more susceptible to economic, business or other developments affecting a sector. Investments in foreign securities may entail unique risks, including political, market and currency risks. There are risks associated with small- and mid-cap investing such as increased volatility, less liquidity, limited product lines, and small market share. High-yield bonds involve a greater risk of default and price volatility than U.S. Government and other high-quality bonds. High-yield/high-risk bonds can experience sudden and sharp price swings which will affect net asset value.

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 our disclosure document, Form ADV, Part II.

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