

Portfolio Update

July 2006

Domestic Market Commentary

Most stock indexes hit a peak in early May and then retreated. They paused near the end of May, but then dropped further in early June. In our opinion, the two-phase drop can be explained by a growing belief that the Federal Reserve Board (Fed) has either tightened monetary policy too much, or the fear that it will soon go too far toward tightening. With this presumption, investors evidently contend the economy will slow to the point of recession. Consistent with the expectation of a slowing economy, the price of oil and gold dropped in tandem with stock prices. As the prices of stocks, gold and oil declined, long term interest rates also dropped – themes which, again, are consistent with the expectation of a slowing economy. Since June 13, however, most indexes have experienced a modest rebound. This rebound in stock prices featured just the opposite theme as oil and gold prices recovered and long term interest rates moved higher. During this period investors reversed their outlook totally, apparently changing their collective mind regarding excessive Fed tightening and the impending slowdown.

Déjà vu

Can investors be wrong with their intuitive, gut-level, economic forecasting? In our opinion, the answer is clearly yes! From July to October, 1990, stock prices (as represented by the S&P 500 Index) dropped about 19% quickly as investors feared that the potential Desert Storm war would hurt the economy. They were wrong. We believe the war had no economic impact and stock prices quickly recovered and resumed their upward path. In July and August, 1998, stock prices experienced a quick 19% decline as investors feared that the recession in Asia would spread to Europe and then the U.S. They were wrong, and stock prices recovered and then resumed their climb higher. In September, 2001, stock prices dropped sharply after the terrorist attacks as investors feared economic fall out. As horrible as the attacks were, there was little economic impact and stock prices quickly recovered. During the last couple of years, stock prices have retreated occasionally as investors intuitively, but nevertheless, we believe, incorrectly, thought that higher oil prices would slow the economy.

ICON has ridden through these events and market declines in the past. We were – and continue to be – guided by valuation rather than top-down economic forecasting. We do not believe it is possible to “time” market moves driven by rapidly fluctuating investor economic outlooks. While the initial drop was unpleasant, we were pleased with the results of riding through the events just described.

We believe that investors should remain in the market and we base our position on a variety of factors. First, is valuation. We believe pricing typical of market peaks that precede bear markets did not occur in early May. In other words, stock prices did not exceed our estimate of fair value as would be typical of a market peak. Next, we contend that investors have continually underestimated and even denied or rejected the strength of the economy over the last few years. Based on our analysis of the numbers, we do not believe that we are experiencing a “slow or slowing economy.” In other words, intuitive-based forecasters have had an underestimating bias the last few years and until proven different, we think that bias is influencing the recent consensus negative outlook, not the numbers.

Industry leadership

A few industries did get over-priced relative to our estimation of fair value in early May. With the retreat in stock prices, many industries are back on sale and ICON's valuation methodology has identified certain attractive situations. It is too early to tell what theme will emerge from this recent decline. The leadership over the past three years has been in small and mid-size companies in industrial, cyclical and economically sensitive industries. Many are commodity-based. Those got hit the worst during the recent decline, consistent with the fear that the economy is slowing. There are new industries showing the *potential* to be leaders out of this recent retreat, but again, it is too early to identify those industries with any degree of certainty. We expect the view from our quantitative system to become clearer in the coming weeks.

Bond Market Commentary

If there is to be a rally in bonds after the Fed is finished tightening, it does not appear to us that it is ready to begin yet. Valuation readings are improving but all of the conditions necessary to entice us out to the long-term end of the bond spectrum are not in place yet. Valuation readings are improving in corporate and Government bonds, but we are keeping both sectors at the short term end of maturities for the time being.

International Market Commentary

The market drops in May and June occurred simultaneously in most international markets. We become suspicious when the correlation gets that high. It suggests to us that the drop is due to intuitive, gut-level economic forecasting, rather than fundamentally driven. Movements based on fundamentals would seem to vary country to country. In our opinion, investors seem convinced that the Fed tightening (and tightening by other central banks) will cause a global recession. Such wide, sweeping economic forecasts are rarely correct.

Given the recent set back in prices, attractive V/P ratios are abundant in our estimation, and still higher than in the U.S.

Summary

We have looked at many factors and we contend that the recent drop is not the beginning of a bear market, but is instead a temporary dip driven by intuitive, gut-level macro economic guessing. There have been many times in recent history when this activity has been incorrect and had only a temporary impact on stock prices. We believe that is the case again.

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.

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