

Portfolio Update

March 2005

■ Domestic Market Commentary

The stock market behavior for the first two months of 2005 is reminiscent of the first 7½ months of 2004. From January 2004 through mid-August 2004, the market moved in a trading range. Investors changed their view of the economy about every three to four weeks, and the market bounced up and down in response. Oil prices were the most influential variable contributing to the market gyrations in 2004. So far in early 2005, the setting appears very similar. Oil prices are generally higher in early 2005, although not to the peak level seen last year.

At ICON, we are approaching the market this year as we always do. The average value/price reading for the domestic stocks in our database is 1.15, meaning we view the U.S. stock market as priced about 15% below our estimate of fair value. With such valuation readings, we own what looks attractive and we ride through market turbulence. With stocks priced that much below our estimate of fair value, we expect the ultimate breakout to be to the upside. Again, like last year, the ability to earn equity returns may depend primarily on patience and discipline. If we are correct and the breakout is ultimately to the upside, we have to be invested to participate.

Catching the industry leadership whenever the market breaks out is just as important as being invested. We were pleased with our industry concentration during the market advance of the final 4½ months of 2004. The market turbulence through mid-August 2004, however, provided no clue as to the year-end leadership. In fact, that turbulence disguised the future leadership and made it difficult to be properly positioned.

Similarly this year, the decline in January and the subsequent advance in February provide no clues as to future industry leadership. All in all, the turbulence is fairly meaningless as investors waffle back and forth with no fortitude in their view of the economy and corporations' abilities to grow earnings.

Sector Adjustments

In this setting, we have made only minor adjustments in our sector and industry positions. The Materials sector has been reduced primarily for valuation reasons according to our strict sell discipline. Many industries in that sector have made great runs over the last three years and have now become overpriced. Positions in Information Technology have been reduced, but more for relative strength reasons. It is difficult to believe that such sluggishness could easily and quickly reverse itself and turn into market leadership.

With those reductions, Healthcare has been increased, primarily to get more exposure to the managed healthcare industry. An addition was also made to Telecommunication & Utilities, entirely to the Utilities portion of that sector. This is not a defensive move; to the contrary, Utilities are underpriced and they have frequently led when the market has advanced.

■ Bond Market Commentary

While traditionally thought of as the conservative part of the market, bonds have become the volatile segment lately. The yield on the 10-year Government Bond dropped in January and inched even lower in February, briefly closing below 4.00%. During the final two weeks of February, the yield shot up to the 4.30% range. At that level the yield still had not reached the short-term high seen in November 2004, but near the high end of a trading range dating back to August 2004.

As in the equity market, every few weeks investors seem to change their views, in this case regarding interest rates and the impact of Federal Reserve monetary policy. Bond yields respond. The Federal Reserve has drained reserves from the banking system, which has raised the Federal Funds rate. Yet M1, M2 and M3, which are measures of the money supply, are still growing. In that setting, the increase in the yield on the 2-year Note appears over-done. The sideways move in the 10-year yield appears sensible to us, although more volatile than necessary.

■ International Market Commentary

Unlike early 2004, the international markets have not moved in sync with the U.S. in 2005. In Europe, markets have had more of a steady upward path, compared to the trading range seen in the U.S. The Japanese market looks a lot like European markets. Hong Kong dipped in January but surged in February. In total, international markets have generally outperformed the U.S. in the first two months of 2005. While sector and industry leadership has not been clear in the U.S. because of the volatility, leadership is fairly clear internationally. Besides Energy, Industrials stands out as a leading sector.

Currency has not helped international returns so far this year as it did in 2004. The U.S. dollar strengthened in January and then weakened in February. Overall, any positive returns seen in international investing are due to stock appreciation, not foreign currency strength.

■ Summary

Analysts and investors appear to be having a difficult time sorting out Federal Reserve policy and its impact, oil prices, currency, and corporate earnings. Unable to form a strong opinion, they bounce around from one news release to the next. This has created short-term variability in the market. Based on valuation, our discipline guides us to ride through it, hoping to get rewarded at the time when stock prices move up to our estimates of fair value.

Yours truly,



Craig T. Callahan, DBA
President

Past performance does not guarantee future results. *Investment return and principal value will fluctuate, so that an investor's shares, when redeemed, may be worth more or less than their original cost. 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.*

An investment concentrated in sectors and industries may involve greater risk and volatility than a more diversified investment, and the technology sector has been among the most volatile sectors in the market. Investments in foreign securities may entail unique risks, including political, market and currency risks. 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 high-quality bonds.

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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Data Source: Bloomberg

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