

# Portfolio Update

## September 2006

### **Domestic Market Commentary**

In late April and early May, we believed market variables were heading toward peak-like, overpriced conditions that typically precede bear markets. Both stock prices and long-term interest rates were rising. Had both conditions persisted, stocks would have become overpriced relative to our estimate of intrinsic value, and our sell discipline would have required us to sell equities and raise cash levels. Instead, stock prices experienced a modest retreat before overpricing occurred.

Since that modest retreat, stock prices have been in a sideways trading range with rapid daily and weekly industry theme changes. We do not fear a bear market because we measure stock prices as generally below our estimate of fair value. In other words, we believe we do not need a bear market to return prices to intrinsic value. They are already below it. Measuring stock prices to be approximately 21%, on average, below our estimate of intrinsic value, we expect the ultimate breakout to be to the upside. While the potential direction is clear to us, the industry leadership for that anticipated move is not clear, but that is typical during sideways trading ranges.

### **Identifying a Theme Change**

At ICON, we focus on identifying industry themes. To do this, we track which market industries are leading and lagging. Most indexes hit a low on June 13, 2006. Since that date, the four best-performing sector indexes as tracked by Standard & Poor's, in order of performance, are Telecommunication Services, Energy, Health Care and Consumer Staples, through August 31, 2006. The worst two performing sectors are Industrials and Consumer Discretionary. Other than Energy, these results clearly suggest to us that investors are favoring stocks that are not economically sensitive or cyclical. Health Care, Utilities and Consumer Staples companies derive revenue that is not dependent on the ups and downs of the economy. To the contrary, they are quite steady, independent of general economic activity. The lagging sectors, Industrials and Consumer Discretionary, include companies whose revenues are closely tied to economic activity.

The Financials sector had some strong-performing industries since the June low, but the extent of the Financials' poorly performing industries prevented it from becoming one of the best four sectors. There are large differences between the extremes within that sector. Some of the leading industries in the Financials sector over that period are diversified capital markets, diversified banks, asset managers and custodians and other diversified financial services. In summary, over this brief period, it appears investors have preferred companies with banking, asset management, and investment banking interests. They share a theme with the leading sectors in that they are not very economically sensitive but they are also industries that would generally benefit from a decline in interest rates. Utilities also generally benefit from lower interest rates.

The Energy sector is unique. Although oil prices are a few dollars per barrel below their recent peak, they are slightly higher than in mid-June. That small advance would explain why that sector is among the leaders over that period, despite not being consistent with the non-economically sensitive theme.

Information Technology, as a sector, remains the biggest mystery during this choppy period. It has led on some brief upward moves, but on others it has not participated. The advances also have appeared very company-specific, rather than broad over the entire sector. Tech may come out of this sideways move as a leader, but, so far, it has not demonstrated the characteristics that we require.

### **Current Portfolio Positioning**

Over the last three years, Energy, Industrials and Materials have been the best performing sectors. Stocks in those sectors are very economically sensitive or cyclical. It is too early to tell whether the market is undergoing a theme change in which leadership will be in Health Care, Financials, Utilities and Consumer Staples. We have made some industry rotations during the first eight months of 2006 in anticipation of that potential theme. At year-end 2005, the Financials sector represented approximately 19% of our U.S. exposure. Now, it is closer to 24%. The Industrials sector has been reduced from around 18% in late 2005 to almost 13%. Leisure and Consumer Staples has been increased from about 3% to 5% and Telecommunication & Utilities has remained at about 5%. These weightings vary across portfolios.

### **Bond Market Commentary**

Based on our recent analysis, we have begun to gradually increase duration. In our opinion, we are not convinced that further Fed tightening, should it occur, will equate to higher longer term interest rates. Naturally, further Fed tightening will boost short-term rates, but not necessarily long-term rates in our opinion.

Some observers believe the Fed has already gone too far, which will slow the economy more than desired. Further tightening, if it occurs, would tip the scales in the “slowing” direction, which, to us, would suggest lower long-term interest rates.

### **International Market Commentary**

Our sector and industry readings are very similar internationally. Our three largest international industry holdings are diversified banks, pharmaceuticals and electric utilities. From a sector perspective, Financials has been increased to the largest weighted sector. This year, holdings in the Industrials sector have been reduced while Telecommunication & Utilities and Leisure & Consumer Staples have been increased. A result of this sector shift has been a reduction in Asian exposure and a shift toward Europe.

### **Summary**

The ICON system is designed to capture themes during market advances. In our view, attempting to profit from company-specific events or weekly industry moves during choppy, sideways markets requires more speculation than investing. We resist that temptation and simply try to identify and shift toward the theme that we believe will emerge out of this period.

Prepared by ICON's Investment Committee.

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*Sources: Bloomberg, FactSet Research Systems, Inc.*

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