

NORTHWEST VIEWPOINT

Third Quarter, 1999

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A Problem or an Opportunity?

By Steve Neff

Senior Vice President, Marketing

Everyone seems to dislike taxes. For the high net worth investor, "dislike" doesn't even come close to expressing their feelings about paying taxes. However, to optimize a client's portfolio and situation, tax implications must be considered. While mutual funds can provide acceptable returns, they lack the ability to accommodate an individual's unique tax considerations. Therefore many high net worth investors have turned to individually managed accounts as the best alternative to manage investment tax issues.

ICM provides taxable investors with individualized tax management. Every year at about this time we mail all taxable accounts a Realized Gains and Losses Report. We encourage our clients to let us know if we need to offset gains or losses and then we make every effort to accommodate their special situations. This time period, from as early as August through October, is referred to as the "tax selling season." While some investors may consider this season problematic, we view it as an opportunity.

Some time ago, as part of an effort to speed up tax collection, the federal government passed a law which has had the effect of mutual funds declaring their taxable gains and losses by the end of October. The end result is that it has not only helped the IRS get their money sooner, but it has also created a significant investment event

for opportunistic investors (read small- and mid- cap value).

Think about this. All U.S. equity mutual funds are attempting to balance taxable gains with losses before the end of October. In other words, if they have gains for the year they are looking to sell any stocks that have losses. This concentrated selling by mutual funds drives the price of under-performing companies even lower, regardless of the companies' near-term or long-term prospects.

Other managers are aware of this action and will often sell in advance of tax selling season. In effect, this pushes the season forward. We have noticed this trend begins earlier every year, especially in the less liquid smaller market capitalization stocks. Very few managers wait until October to take tax losses.

ICM has used this event to our advantage often and this year is no different. If you have a taxable small- and/or mid-cap account you may have noticed cash levels rising over the past several months. This cash is the direct result of some of our own tax selling in addition to our normal process of trimming stocks as they become overweighted in a portfolio due to appreciation. You will begin to see cash levels declining over the next few months as we take advantage of this predictable annual event.

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This can prove to be a very profitable time for patient investors with a longer-term investment horizon to go “shopping.” Hey, if we were in the retail clothing industry this event would be declared a “GIANT BACK TO SCHOOL SALE.”

“While some investors may consider this season problematic, we view it as an opportunity.”

We request that clients advise ICM and their broker/consultant in the event that there are any changes in their investment objectives, financial situation, or whether they wish to impose or modify restrictions on the management of their account. Please call ICM’s Client Services team at (800) 488-4075 if you have any questions or need additional information.

Taxing Matters

By John Simms, CFA

Senior Portfolio Manager, Fixed Income

In keeping with the overall theme of this quarter’s newsletter, let’s discuss the tax considerations related to the active management of a municipal bond portfolio.

Some bond investors find bond transactions cumbersome and difficult to quantify. For example, selling bonds before maturity for reinvestment can be a complicated task. Bond trades can also be more expensive than similar sized stock trades when you factor in implicit yield concessions. For taxable investors, the tax implications of capital gains/losses and market discounts adds complexity to the common yield comparisons used as a basis for determining when to trade.

This confusion leads many muni-bond investors to minimize trading, resulting in a broadly held preference for using bond mutual funds or passive “laddered” portfolios where bond maturities are staggered evenly over time.

Certainly mutual funds and/or a passive portfolio of municipal bonds are accessible and are appropriate options for some bond investors. How-

ever, as portfolio size and investor tax complexity increase, the benefits of pursuing active muni-bond portfolio management can become significant. Let’s take a look at three levels of tax evaluation that affect bond investors.

The Big Picture

The first level of tax evaluation is to identify the investor’s tax rate (frequently the highest federal marginal tax rate), and then determine after tax yields across fixed-income markets. This evaluation is essential, and optimally should be expanded in several dimensions.

The common Municipal-to-Treasury yield comparison should be expanded to a full range of taxable alternatives. The impact of state income taxes between municipal issuers and all taxable alternatives should be considered, and investor specific tax circumstances (such as potential alternative minimum tax liability) must be identified. A better basis for portfolio creation can only be established through consid-

eration of an investor’s complete tax environment.

Trade Decisions

The second level of tax evaluation relates to the trade decisions associated with active bond management. As alluded to above, the very existence of tax implications for municipal bond trading likely dissuades many investors from pursuing active management. Even professional publications that discuss such tax implications may simplify their analysis and focus on buy/hold decisions based on computing the tax liability of realized gains.

An active manager should pursue efficient, low cost trade execution, consider the different tax treatment of trade candidates, and not overlook the structural market opportunities that may allow portfolio income to remain stable or increase even while taxable gains are realized. (Please inquire for a demonstration of such opportunities.)

Ongoing management must also continually reevaluate the tax considerations noted at the first level, recog-

nizing that investor circumstances are fluid and inter-market relationships change constantly.

Offsetting Realized Gains & Losses

The third level of tax evaluation relates to trading strategies used to minimize the impact of realized gains and losses at tax time. While offsetting gains and losses may be a common practice for stock investors, they should be considering all asset classes, muni-bonds included, when identifying the optimal choice for tax-oriented trades.

If used to offset similar gains in stocks, realized losses on bonds can provide an excellent opportunity to increase portfolio yield through rein-

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vestment. Alternatively, realized gains on bonds may potentially be used to offset similar losses on stocks, while maintaining portfolio yield. Of course, this type of tax evaluation requires cross-asset manager coordination.

Rise Above the Confusion

The tax benefits gained from pursuing active muni-bond portfolio management can be significant, especially for the high-net worth individual. Before giving in to the complexity and settling for a laddered muni-bond portfolio, be sure to weigh the alternatives and consider what you have to gain from an active management.

“...the benefits of pursuing active muni-bond management can be significant.”

The Few, The Proud, The CFAs!

Exam results from the Association for Investment Management and Research (AIMR) are in and we are proud to announce that ICM Research Analyst Rich Beaven has joined the ranks of Chartered Financial Analyst. With Small- and Mid-Cap Value Research Analyst Beaven’s recent accomplishment, ICM can now boast of six investment professionals that hold the CFA charter.

Kudos also go to Small- and Mid-Cap Value Research Analyst Tony Bennett, Associate Portfolio Representative/Equity Research William Lang, and Associate Portfolio Representative Dan Cronen for all passing Level I of the three level examination.

For those of you not familiar with the CFA designation, the program is designed to provide an educational process to further develop financial skills specific to the investment management industry. The program’s broad-based curriculum includes core areas from portfolio management to asset valuation to derivatives and quantitative analysis. In addition, AIMR encourages members to demonstrate their commitment to learning by participating in their formal continuing education program.

AIMR only awards the CFA designation to individuals who meet a number of requirements. These include passing three sequential exams (administered once a year in June); attaining three years of experience in financial analysis; and pledging to adhere to the code of ethics that governs the conduct of those holding the CFA charter. CFA charterholders are also required to be a member of a local Financial Analyst Society.

Taxed Out?

By Bob Lewis

Senior Portfolio Manager, Large-Cap Growth

Investing 101 tells the new investor to focus on three factors: potential investment return, taxes and transaction costs (principally commissions). These factors are ranked with potential investment return at the top of the list as the most important factor to consider.

Investment return is defined as price appreciation plus dividends. For example, if a \$20 stock moves to \$21 and also pays a \$1 dividend, the total investment return is \$2, or 10 percent. However, this total return may be reduced, as most shareholders have to pay taxes of varying degrees. Because tax rates differ from person to person it is difficult to generalize a definitive after-tax investment return. This is why most investment performance comparisons for stock market indices, mutual funds and universes are stated on a pre-tax basis.

There isn't anything wrong with omitting taxes, unless of course one is filing a tax return with the IRS. And there isn't anything wrong with an investment manager taking capital gains; unless of course, his taxable customer is disadvantaged in the process of taking those gains. Just because death and taxes are certain, it doesn't mean that one shouldn't try to defer them. (Unfortunately, the only advice we can offer concerns taxes!) So what should a taxable customer who is concerned about avoiding or deferring taxes be looking for in a large-cap growth investment manager?

Portfolio Turnover

We believe that excess portfolio turnover is a highly important yet often overlooked contributor to investors paying too many taxes. What exactly is portfolio turnover? For the sake of this article we define portfolio turnover simply as the lesser of the amount of buys or sells as a percentage of the average market value of the stock portfolio.

In a recent *Wall Street Journal* article, Morningstar Inc. estimates that investors "in diversified U.S. stock funds surrendered an average 15% of their annual gain to taxes over the five years ended July 31." The article states that one extremely rapid turnover fund had after-tax gains 39% lower than its pre-tax gains. (Lest we be accused of picking on mutual funds, note that the turnover rates of individual portfolios are less available for scrutiny.)

High turnover managers often argue the "pay as you go" philosophy of taxation which tells their customers that since you will have to pay taxes eventually, why not just pay them now? Do they also tell customers since they will eventually have to die, why not today? This flawed philosophy would also make tax accountants, attorneys and estate planners excess baggage for the investor.

After Tax Returns

Another argument commonly used in favor of high turnover is that it is justified if after-tax returns are extraordinarily high. Unfortunately the evidence points to a different conclu-

sion, as evidenced by the chart below.

The "Alpha" column shows the portion of investment return attributable to the investment manager, not the stock market itself. A positive alpha would indicate the manager was

Group	Alpha
<i>High Turnover</i>	-2.21
2	-1.87
3	-2.17
4	-1.11
<i>Low Turnover</i>	-0.58

Source: *Modern Portfolio Theory and Investment Analysis, 5th Edition*
Edward Elton and Martin Grober

"adding value" to the portfolio returns. As the table indicates, there is an inverse relationship between turnover and Alpha. In fact, the negative alpha indicates "value subtracted" by high turnover managers. Over the years other studies have reached the same basic conclusion — high turnover is coincident with lower investment performance.

For the taxable investor, investment returns, taxes and hidden costs such as portfolio turnover are interrelated to each other, and directly related to the real success of an investment program. It makes sense to select an investment manager that pays attention to the tax liabilities of investors and avoids an overly active buy/sell regimen for taxable investors.

"...excess portfolio turnover is a highly important yet often overlooked contributor to investors paying too many taxes."

ICM Year 2000 Compliance

By J. Scot Urquhart

Manager Information Systems

With the century rapidly coming to a close, many clients have inquired about ICM's Year 2000 compliance status. In June of 1997 we formed a Year 2000 committee and started work on our Year 2000 planning. We recently completed the Assessment, Inventory, Renovation and Testing phases of our Year 2000 project and wanted to share this process and our results with you. ICM now considers itself to be Year 2000 compliant within the framework of this process.

Assessment Phase

ICM's Assessment Phase consisted of reviewing our business functions, the technology that supports them and the possible impact of Year 2000 on those systems. This assessment identified internal systems, which consisted primarily of hardware and software, and external systems, which

"ICM now considers itself to be Year 2000 compliant..."

consisted primarily of third party vendors and service providers we rely on for products and services. From this assessment we categorized the systems as either mission critical (systems vital to the primary operations of ICM) or non-mission critical (systems used to supplement our primary operations). We then developed a plan that addressed all mission critical systems for Year 2000 compliance with renovation taking place as needed. This plan was then applied to non-mission critical systems.

Inventory Phase

The Inventory Phase consisted of creating a list of components for each of the systems outlined in the Assessment Phase. Again, this phase covered ICM's hardware and software, both internal and external, as well as our vendors and service providers.

Testing and Renovation Phase

Hardware and software systems, both internal and external were tested for compliance. In the case of failure, the system was either upgraded or replaced and then re-tested for compliance. This process was repeated as needed until a compliant status was achieved.

For vendors and service providers where testing could not be performed, a statement of compliance was requested confirming their compliance. ICM's mission critical vendors all responded positively, indicating that they are taking the steps that they believe are reasonably required to address their Year 2000 issues.

It is important to ICM that we verify the compliance of our vendors and service providers. However, we must rely on the accuracy of their Y2K policies and signed statements of compliance.

Portfolio Holdings

ICM has also taken into consideration the potential impact of the Year 2000 on our portfolio holdings. When our research and portfolio manage-

"...we have done everything reasonably necessary to prepare our customers and ourselves for the Year 2000."

ment teams are evaluating securities for potential new or continued investment, they take into account the extent to which the issuer has prepared for the Year 2000.

At this time, ICM has completed the phases listed above. As a registered investment adviser, we feel a fiduciary responsibility to remind you that the potential impacts of the Year 2000 on ourselves, our clients and the value of the companies in which we invest could be material and adverse. However, we feel that we have done everything reasonably necessary to prepare our customers and ourselves for the Year 2000.

ICM is looking forward to ringing in the new century with all of you and feel that we have made all reasonable efforts to make this transition a smooth one.

If you would like more information on ICM's Y2K policy, or would like a copy of our SEC Form ADV-Y2K, please call our Client Services team at (800) 488-4075 or (509) 455-3588.

▶ Index Returns

Third Quarter 1999

	3Q99	YTD
<i>Large-Cap Indices</i>		
The Dow	-5.37%	13.96%
S&P 500	-6.25	5.36
Russell 1000	-6.60	4.18
Russell 1000 Value	-9.80	1.81
Russell 1000 Growth	-3.66	6.40
<i>Mid-Cap Indices</i>		
Russell 2500	-6.45	3.74
Russell 2500 Value	-8.64	-2.49
Russell 2500 Growth	-3.47	11.57
<i>Small-Cap Indices</i>		
Russell 2000	-6.32	2.37
Russell 2000 Value	-7.82	-2.97
Russell 2000 Growth	-4.92	7.27

Sources: Bloomberg, L.P.; Frank Russell Company; IDC



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