

## QUARTERLY COMMENTARY

### OCTOBER 2011

---

#### OVERVIEW

In spite of our many years of investing experience, it's always remarkable to us how one quarter's performance can differ so much from the prior one when the news background remains so similar. That was certainly the case in the third quarter. The U.S. economy continued to stumble along; the European economies wrestled with their weakest sibling, Greece, and the emerging economies tried to figure out their growth prospects in the face of several weakening developed world economies. That was the essence of discussions in the second quarter as well, but the markets' behaviors were dramatically different: equities were up nicely in Q2, then down sharply in Q3. Bond market behavior was also very different quarter-to-quarter. Yields were relatively flat in Q2 and down sharply in Q3. What explains the difference? Mostly a decline in growth expectations on the part of some investors for the U.S. economy. Now that they have adjusted their expectations to a more reasonable set of possibilities, we think the market can stabilize—and provide better equity returns.

The interest rate outlook is stable. With an economy that is weak and inflation still restrained (although gradually trending upward), there does not seem to be enough inflation pressure to threaten bond values (yet). Bond market returns, as a result, will probably remain modest, but the risk will be to the downside based on future events. Treasury yields dropped during the third quarter of 2011, mostly driven by the continuing debt crisis in Europe and the Fed's Operation Twist. The rate on the 10-year note touched a high of 3.27% in early July and a low of 1.82% in late September, before settling at 1.97% at the end of the period. Based on the slowed recovery, the latest testimony by Mr. Bernanke and Fed minutes, the Federal Reserve won't start hiking interest rates until 2013.

#### PRODUCT PERFORMANCE AND ATTRIBUTION



##### *Small Cap Intrinsic Value – Portfolio Manager, Kyle Knigge, MBA, CFA*

The mantra throughout the third quarter continued to be uncertainty, volatility, Greece/Europe and slowing global economies. We occasionally heard about these subjects in the second quarter, but this past quarter saw the amount of uncertainty rise sharply as both economic and political unrest increased. As a result, we saw volatility rise and investors grew more reluctant to take on risk, thus driving performance of many indices into a sharp decline, especially for the stocks of small companies and value stocks in turnaround mode. Any additional uncertainty surrounding companies' prospects for revenue or earnings growth appeared to exacerbate the willingness of some to liquidate those stocks even more than that of the underlying index. Our cash and sector allocation within the portfolio added slightly to performance versus the Russell 2500 Index, while we had some lagging performance from our stock selection. We believe this underperformance can be attributed more toward risk aversion than to specific corporate events. We remain very optimistic about our portfolio companies.

Takeover activity is again becoming a factor in results. We had two companies become takeover candidates in the quarter and we believe, as valuations continue to be depressed, that this activity may increase in the next couple of years. In the second quarter we mentioned that we had raised a significant amount of cash as many companies in the prior few quarters had reached our price targets. Since mid-August we began deploying some of that cash into newer investment ideas, continuing throughout the third quarter and into the beginning of the current fourth quarter. We still hold a fair amount of cash, yet are finding very good companies trading once again at exceptionally low historic valuations. From our perspective, macro economic uncertainty will likely remain for a period of time, yet many companies aren't as reactive as they were back in the panicky slowdown in late 2008 and 2009. In fact, many appear to be strategically deploying capital in areas that will assist their growth or enhance their productivity during these trying times. So, if the macroeconomic backdrop remains stagnant then

their earnings should hold up better. On the other hand, if the economy improves, their better operating leverage could lead to substantial improvement. Therefore, our focus continues to be on individual companies with prospects for growth and operating improvement, good balance sheets, strong management teams, that are priced well below a more normalized valuation.

### ***Large Cap Globally Dominant – Team Managed***

---

The large cap globally dominant portfolios suffered through the quarter in similar fashion to the small cap, although the accounts generally performed in line with or better than their negative benchmarks. The S&P Global 100 declined 17.4% and the S&P 500 declined 13.8% during the quarter. As mentioned above, the equity markets struggled due to an array of outside influences in spite of good corporate profitability. The fears of a possible global slowdown, triggered by unresolved European problems and the slipshod political process in the U.S., were the biggest culprits.

The selloff, however, has not discouraged our optimism for the large, mostly American companies that have dominant positions in many world markets and who have become compellingly cheap thanks to this recent correction. We remain convinced that the steady increase in productivity throughout the emerging and developing world will drive incomes for the residents of these countries, resulting in a very significant increased middle class population, which the global companies serve most effectively.

The other attraction of these companies is their increasingly compelling dividend yields. With interest rates at lifetime lows, and likely to drift higher in coming years, the dividend yields are growing more important as an alternative source of investment returns. We believe this attraction will grow more important with investors facing the unappealing low yields in today's fixed income markets.



### ***Fixed Income – Portfolio Manager, Torsten Lippoldt, MBA***

---

ICM has recently preferred a conservative bond strategy emphasizing quality and short maturities. This resulted in our taxable bond portfolios, on average, underperforming compared to their designated benchmarks during the period. Taxable bonds were hurt by unfavorable spread-widening across all sectors due to the slowing economic recovery domestically and abroad, as well as the financial crises in Europe; financial names in particular were affected the most. Selective trades helped to capture gains and performance. Tax-exempt bond portfolios, on average, slightly underperformed their designated benchmarks during the period, as a result of our quality and short maturity bias. While tax-exempt bonds benefited from general price appreciation, most of ICM's portfolios are limited to certain geographic areas that we consider economically healthier and at times we will forgo greater performance gains because of it. Issuance in the municipal bond market was average as municipalities have to continue funding day-to-day operations. As of September 30, the average yield for a 10-year A rated corporate bond was 4.25% and the average yield for a 10-year A+ rated municipal bond was 3.29%. The Barclays Capital Intermediate Govt/Credit Index and 5-year Municipal Index increased by 2.39% and 1.97%, respectively, during the quarter.

## **LOOKING AHEAD**

**Equities** – Will we get a repeat of 2008 and 2009? Anything is possible given the political and macroeconomic backdrop we have experienced over the last several years. Things haven't changed that dramatically on either count. However, corporate America appears to be much more stable and ready to adapt effectively to additional turmoil than they were a few years back. The jobs picture has slowly improved and the housing market has shown some stabilization, but foreclosures, pricing and inventory have further to go before one can say that stability is at hand. Government actions by regulatory and elected officials will continue to evolve and will no doubt create more uncertainty that will weigh on the investment community's psyche through next year's presidential election. So, challenges remain.



Two very positive items we discussed last quarter have not changed though: (1) corporate income statements and balance sheets have continued to get stronger, and (2) most global economies continue to show some growth while emerging markets haven't showed significant slowing. We are watching this closely as China's growth moderates, but we have recently grown slightly less anxious about the prospects for a severe Chinese slowdown. Finally, Europe appears to be limping toward a reasonably constructive effort to solve (or at least substantially defer) the EU's sovereign debt problem. This gives us some hope that once some of these aforementioned uncertainties finally alleviate, the equity markets will find stability and moderately rise again. Additionally, with the excellent value that once again exists, we are more upbeat than we have been in several quarters.

**Fixed Income** – Security selection will be the most important driver of returns through the rest of the year. Much of the movement in rates will depend on the domestic and global economic and monetary picture. Corporate bond issuance is expected to be moderate amidst economic uncertainty, but also expect to see continued merger and acquisition (M&A) activities. Municipal bonds should continue to recover as municipal revenues slowly increase and refinancing takes place. Interest rates will continue to be driven largely by overall expectations and the impact of the European debt crisis on global financial markets. We anticipate inflation to be tame for some time to come. Going forward, we will continue to apply individual fixed income investment strategies that are specifically designed to handle a dynamic interest rate environment.

As always, our goal at ICM is to provide superior returns for our clients, while minimizing risk. Sufficient diversification has been and continues to be one of our primary risk management principals. Our active approach to investment management with these goals firmly in mind continues to guide our daily efforts.

---

*We request that clients advise ICM 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 at 800.488.4075 or visit our Web site, [www.icmasset.com](http://www.icmasset.com), if you have any questions or need additional information.*

