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THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Investing in Small Cap Value Stocks

JIM SIMMONS, founder of ICM Asset Management, Inc., is the firm's Chief Executive Officer and Chief Investment Officer. He has over three decades of experience in financial services, and investment and trust management. As the firm's Chief Investment Officer, he also oversees strategy for all equity portfolios. Before founding ICM in 1981, Mr. Simmons served as the head of Old National Bank's trust investment department, and prior to that, was a portfolio manager with the bank now known as Comerica. He earned a Bachelor's degree in Economics from Michigan State University, he is a Chartered Financial Analyst and is a member of the CFA Institute and the CFA Society of Spokane.

TWST: Would you start with an overview of ICM Asset Management and its investment philosophy?

Mr. Simmons: We are an opportunistic investor in small cap and small to mid-cap value equities. Some people call us a deep value investor, because we tend to go fairly deep into various company turnaround stories. We prefer to characterize ourselves a little more as a firm that buys intrinsic value at a discount when many others harbor doubts on the future prospects for a given company. In any case, we are bargain hunters who are rotational through the sectors over time and opportunistic in order to capture those newly evolving bargains when they are available and poised for earnings recovery.

TWST: What is the investment climate like now with all the turbulence in the markets? Is this a good time for out-of-favor companies?

Mr. Simmons: We think it has become a good time now, but it wasn't particularly good 60 or 90 days ago. When a market goes into turmoil, like it has amid the panic emanating from the credit markets, it creates numerous individual opportunities. As a practical matter, our experience tells us that anything that is in a turnaround stage will decline when the broad equity markets are in turmoil. Very few investors will look across the "valley" of the stock market trauma to invest in turnarounds, whether they are sector-driven or company-specific. Most investors in a tumultuous market environment, such as we have currently, simply won't step up and buy new turnaround stories. I think they figure it can be postponed; they are thinking in terms of being risk averse. Turnaround stories in their early phases are usually perceived as risky in a short-term time frame. The irony is that a market selloff and the resultant lack of interest create the opportunity to buy bargain companies. We are going through a period when a lot of these turnaround stories have actually been hit hard because of the lack of short-term visibility. Their long-term merit, we believe, is compelling.

There is also another consideration. We think it's a good time to be investing if you're selective about the sectors. We are decidedly downbeat on the prospects for consumer spending growth and we think the economy is going to slow markedly. But we find that a considerable number of companies are either extraordinarily cheap versus their reasonable normalized expectations, even with a slow economy, or they have significant enough foreign exposure that we think their growth outlook is pretty dependable.

TWST: You invest in small caps, and a lot of the experts were saying everyone should be moving into the larger cap stocks? What is the environment in the small cap arena?

Mr. Simmons: It's interesting. If you look at what's happened year to date, the smaller the market cap, the poorer the performance. If you break the Russell 2000 Value down into quintiles, the two bottom quintiles are down by 9.1% and 7.6% through early September, whereas the top quintile, the largest 20% of the companies, is only down 1.7% for the same period. If you look at performance based on companies with unpredictable earnings outlooks for the next 12 months, like many turnarounds, they are also down by 9.5%.

As a practical matter, the decline in small caps as a result of the belief that people should go to safe big caps is already somewhat priced into the market, especially with the smaller and more controversial companies that have suffered. The reality is that they have been underperforming for some time. They've been in their own bear market when compared to mid- and large cap stocks for a while.

So we find quite a number of these companies to be excellent values at this point. It requires that one look past the confusion in the credit markets. Lately, the equity markets have been extrapolating from the mechanical problems in the mortgage and collateralized debt markets to the more fundamental question of deteriorating housing and its ultimate effect on the overall economy. All of that obviously is weighing on people's conviction about how bad the economy will get. If you roll it all together, I think you are probably going to see most investors stay away from small for a while longer, but the fundamentals for the companies that can still grow will ultimately win out, and in some cases, we've seen a few portfolio stocks that are moving up in this period already. The current conventional wisdom says you should buy big cap, but that conventional wisdom has already created, in our mind, some extraordinary bargains, especially on the smallest end of the small cap range.

TWST: How many stocks generally are there in the portfolio, and does the number fluctuate?

Mr. Simmons: The number of issues goes up and down somewhat as we increase or decrease the average capitalization of our stocks. The number of portfolio names increases as our average market cap gets smaller because those are riskier, more thinly traded companies, especially considering the lack of liquidity when you are wrong. Therefore, as we use smaller companies, we tend to use a few more names and smaller average size positions. The reverse is also true. As we increase our use of larger small cap names, we are able to buy larger positions and, hence, hold fewer names. The number will run from 45 or 50, as the fewest number of names, when our average or median capitalization is higher, and it can run up to 60 or 65 companies as we move into smaller caps where we wish to spread it around more. The smaller end of the small cap and small to mid-cap segment is where the best opportunities are presently. Thus, you will see us modestly increasing the number of names right now.

TWST: How has your portfolio shifted in emphasis over the past 12 to 18 months?

Mr. Simmons: Eighteen months ago, we were concerned about the risk to the consumer-led part of the economy, which is roughly two-thirds of US GDP, as a result of the risk to housing prices and home equity. The potential problem has been, as we all know now, the inevitable failure of the consumers' ability to use their home value as an ATM, constantly tapping home equity. We have been moving away from the consumer sector for some time, believing strongly that it was going to be essential to move the portfolio into segments of the economy that would ultimately be very little or not at all dependent on the consumer and where unit growth and pricing power remain reasonable expectations.

Consequently, the portfolios have been steadily evolving. In the consumer sector, we've been fortunate to have several of our consumer turnaround stories purchased as takeover plays — some strategic, some by private equity buyers — which has helped reduce the sector weight. In the meantime, in what may seem counterintuitive for a value investor, we have steadily increased our investment in technology. We believe that technology has the potential to be especially rewarding. Outside the US, growth rates are higher and most technology companies sell worldwide. Our preference is for companies where we believe growth rates are still sustainable and where pricing power is strong enough for those companies to preserve margins because of the proprietary aspects of what they do. We believe this will allow those stocks to generate predictable returns going forward based on that international exposure.

TWST: What are the valuation metrics and the investment criteria that you look for in these potential holdings?

Mr. Simmons: It really varies from industry to industry. Traditionally, if you look at us across an average for the portfolio, you'll find that we buy companies at a discount to the average for that market cap range based on price to sales, price to book, and forward-looking price to earnings ratios. It varies, however, from industry to industry regarding what metrics are pertinent.

TWST: What are some of the stocks that you think are representative of your approach and the reasons why you are attracted to them?

Mr. Simmons: There are three areas that we are emphasizing currently. One is technology in the broad sense, as I mentioned. The other two are really infrastructure-driven. We consider energy infrastructure to be a somewhat distinct market from some of the other kinds of infrastructure companies. While the valuations have grown in recent years, we have found that with the selloff since late July, some of the oil service stocks are again attractive. We have investments in companies in the oil service sector like Input/Output (IO), Cal Dive (DVR) and Horizon Offshore (HOFF). Other infrastructure plays that are not exclusively dependent on energy are companies like Shaw Group (SGR) and URS Corp. (URS). These are areas where we think they can continue to grow even if the consumer slows down.

TWST: You mentioned technology in a broad sense, but are there any specific areas that you would like to mention?

Mr. Simmons: We think much of technology today is driven by growing telecom demand around the world. There are product manufacturers in that sector like an Andrew Corp. (ANDW), which is actually in the process of being bought by a strategic buyer or Powerwave (PWAV), a somewhat similar company in nature.

Those companies are building equipment for the worldwide telecom market. In a related area are the companies that build the components or the equipment to make those components that go into telecom products. These are companies like Lattice Semiconductor (LSCC) and Vishay Intertechnology (VSH); these are what we would tend to call nuts and bolts technology companies.

TWST: What about some of the other out-of-favor sectors where you have found selections?

Mr. Simmons: Prior to the recent selloff, it's been our opinion that many sectors were comparably priced. There are a couple of sectors that have become cheap fairly quickly, but in neither case do we consider them properly poised for a turnaround soon. They're not potentially ready to outperform the rest of the market for a couple of years. Much of the consumer sector, we think, will be seriously constrained for several years to come. The unwinding of home valuation issues, aside from all of the financial subprime issues, will be a persistent drag.

It's been our sense all along that the housing hype has been way overdone. It became something of a bubble and that unwinding will slow the consumer down, because not only can they not borrow more, but many will have to deleverage. So even though many consumer stocks have become fairly cheap, we think it's too early to raise one's bet in the consumer sector, unless on a company-by-company basis, we think something is a compelling turnaround.

The other challenged area is small cap financials. We think that it will probably be 18 months to two years, perhaps even longer, before the financials can convincingly demonstrate that their fundamentals have bottomed. That's because of the unraveling of all this home loan exposure and the deterioration of the housing market, which will significantly impact their loan quality and loan loss reserving requirements.

TWST: How long do you like to hold your companies?

Mr. Simmons: Our conventional goal is 18 months to two years. We wouldn't rule out longer, but we think you have to be that far ahead of the crowd to truly get good value.

TWST: What about the turnover and the sell discipline that you utilize?

Mr. Simmons: Our turnover rate tends to be surprisingly consistent, around 60% to 65%. Depending on the year, it may creep up or down somewhat. Due to the number of buyouts we've had this year, it's a little higher simply because the acquirers end up liquidating our positions prematurely. Without the private equity boom, turnover will likely slow down. We could, of course, own a company for several years. It doesn't bother us, if a company is making steady progress and still has a modest valuation, to own it three or four years.

The sell discipline is built around two complementary processes. On the one hand, we would love to sell every stock based on its fulfillment of our expectations. When this happens we will initially reduce and subsequently sell the entire position in a stock as it reaches our predetermined target prices. These target prices are based on our expectation of how the equity markets will perceive each company's progress 6 months, 18 to 24 months, and several years into the future. They are based on financial metrics appropriate for each industry, but will never assume more than normalized profitability for each company when their industry is healthy (often recovered). On the other hand, when a company is not meeting our expectations, we have a policy that leads to re-researching the company to determine if we are wrong, in which case, we sell or if we are just early, we will hold and possibly add to the position.

TWST: What about the risk management techniques for these companies? Do you control risk at the portfolio level and at the individual security level?

Mr. Simmons: Our control of risk at the portfolio level is largely a function of getting adequate diversification across the various economic sectors, while at the same time not inhibiting our ability to be somewhat opportunistic. It's also controlled through the mix of individual companies by having a large number of companies that have very strong balance sheets, even small companies that frequently have significant net cash on the balance sheets. Approximately 10% or less of our portfolio is in companies that have significant financial leverage that's not a normal function of their business model. In other words, a couple of the companies that we own in the financial services area have debt as a natural function of being a financial company and the equipment leasing companies have debt to finance their equipment. But as a practical matter, except for those companies, we try to control the risk by making sure that in an environment like this, the portfolio companies have strong balance sheets and aren't going to have to go to the market for any kind of debt.

TWST: What do you do to avoid the so-called value trap?

Mr. Simmons: Ultimately, the only solution to avoiding value traps is to make sure that you get the company fundamentals right. One has to understand each company's business model well enough to ensure that the company will fundamentally recover as expected. We focus on what we believe are the critical catalysts. We may be early, but ultimately each company should deliver.

As we mentioned a moment ago, we do occasionally make mistakes, so we have a policy that if a stock declines by roughly 15%, or simply underperforms the rest of the portfolio or the market by a material amount for a one- or two-quarter period, we go back and re-research the idea, essentially from the ground up, to make sure that we haven't made a mistake. If we conclude that we have, we are obliged to sell the position. If not, and we are satisfied that we understand the company's model correctly, that our timing is just early, then quite often, we will buy more.

TWST: Tell us about the mid-cap and larger cap strategies that you use at ICM.

Mr. Simmons: Our mid-cap portfolio is really a small to mid-cap value, as our forte is small company investing. We have a small amount of large cap that is oriented toward a globally dominant portfolio structure and uses companies that have dominant positions within their industry worldwide. It has done fairly well, but we consider it a development stage product. Everything else is small or small to mid-cap value and the methodologies are the same. The overlap is very substantial between the small and small-mid strategies, with the only difference being the market cap range that limits some stocks to one portfolio or the other.

TWST: Have you seen more interest in the international exposure of stocks that deal abroad?

Mr. Simmons: I think everyone who listens to the pundits on CNBC and the like hears a continuous dialog about investing internationally to mitigate the risk of a slowdown in the US. What you don't see very many speakers in the public media pointing out is that there are a large number of small companies that also have a preponderance of their business outside the United States. We certainly agree with anyone who thinks one's portfolio needs to have significant foreign exposure to do well in the next few years. We just happen to think, unlike most of what you conventionally hear, that you can achieve that in small cap as well as in large cap.

TWST: What do you think differentiates your small cap value approach from that at other firms? What are you bringing to the table that others might not?

Mr. Simmons: We are clearly more opportunistic. We are more willing to go into "broken" sectors or "broken" companies than maybe many other value investors are. It just takes longer for these companies to deliver.

We are also definitely willing to be significantly different from the sector weightings that one would customarily expect in a small value index, such as the Russell 2000 Value or the Russell 2500 Value. Our opportunistic and rotational style tends to make us look very different in our sector weightings from the value indices. For those people who believe that you have to be opportunistic over time to repeatedly achieve good results, that's what we believe we are good at.

Looking ahead, in a market that's less likely to be driven by appreciation in the financials, we believe our more flexible and less index-centric approach has the likelihood of producing better returns. This approach allows us to exploit a larger set of options that, in this changing world, is an essential precondition to outperforming over the next several years.

TWST: Who are your typical clients? Are they mostly individual or do you have institutional also?

Mr. Simmons: We have both. By sheer number, we have more retail clients than we have institutional, but we also have some large institutional accounts that exceed the $100 million size per account.

TWST: Is tax efficiency of concern to some of your investors?

Mr. Simmons: For those clients that have a net worth and sensitivity to taxes, we opportunistically take losses throughout the year with the goal of trying to maximize tax efficiency. Our goal is to maximize long gains and minimize short gains. So we will double up a position or sell out and occasionally re-buy another time during the year, even in the first few months, if it seems appropriate for a particular stock.

TWST: What problem areas or possible challenges do you foresee down the road that investors should be wary of?

Mr. Simmons: Clearly, the one that everybody is conscious of right now, and I think nobody can truly quantify the magnitude of the risk, is how much the problems in the mortgage market will spin into lower real estate values or affect the borrowing needs for various parts of Corporate America. First and foremost is the unraveling of all of this debt and the lack of an appreciation for risk over the last couple of years. We still believe that this problem is manageable and characterize it as a mechanical problem within the financial industry that won't spill over excessively to the rest of the US economy. However, there is a risk that it could, and that possibility, we think, is the first thing people need to look for.

A second concern is that to the extent that you invest a significant portion of your assets overseas — anywhere outside of the United States — you want to be comfortable that those economies are solid even if the US weakens. Everyone talks about the potential bubble in China, for instance. At some point, if the rapidly growing largest countries in the emerging markets have trouble selling to the US and start running out of momentum, it could spill over into a broader slowdown for the world, but we think it's too early to try to predict that right now.

TWST: What advice would you give to investors about investing in the market at this time?

Mr. Simmons: Focus on the companies and spend as little time as possible focusing on what you think the market is going to do in the next month or two.

TWST: Thank you.

Note: Opinions and recommendations are as of 9/24/07.

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