



Second Quarter 2010 Portfolio Commentary

Performance Metamorphosis

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As Gregor Samsa awoke one morning from a troubled dream he found himself transformed in his bed into a monstrous insect.
 - Metamorphosis, by Franz Kafka

To be fair, the second quarter was not that bad. While our performance wasn't heroic, it did not devolve into monstrous insect status. It just feels that way, after such a splendid run of good relative performance, five quarters in a row. In 15 years, we've strung together three streaks of five or more quarters of beating the Index. The longest streak lasted seven quarters!

For the quarter, the Russell 2000 was down 9.9%, while our small-cap composite was down 10.7%, a lag of 80 basis points. For the year, we are ahead of the Index by 128 basis points, down 67 basis points versus -1.95% for the Russell.

The market became much more volatile in June, what with the prospect of another global macro shoe dropping, fears of a double dip recession, state and federal fiscal woes and a brewing political showdown. This time, the market tumbled down, rather than climbed, a wall of worry. So much for truisms.

Put a fork in the garbage rally and turn it over. It's toast. Unsurprisingly in a market ruled by fear, there was a flight to quality in May and June. The low ROE stocks, non-earners and stocks priced below \$18 (the bottom two quintiles of the Russell 2000) hit the skids in May and June, all down double digits, after leading the pack in April.

Normally, a rotation toward quality benefits us. We are, after all, not fans of dumpster diving. And, in two out of three months we behaved as expected: we lagged in April's rally (2.79% vs. 5.66%), and we gained relative ground in May's decline (-5.76% vs. -7.59%). In June however, when the market fell apart, so did we (-7.75% vs. -7.75%).

Our top three losers in the quarter (Sotheby's, Resources Connection and Allscripts) cost us 226 basis points, while our top three winners (Gartner, United Natural Foods and Rovi) only gave us a 43 basis point lift. While this is not unusual in a quarter that's down 10%, the portfolio was bottom-heavy. No single loser cost more than 80 basis points, but 14 stocks nipped us for at least 40 basis points each. Our best stock only helped by 19 basis points. In short, no TNT, but enough cherry bombs to hurt.

There's nothing worse (OK, there are a few things worse) than watching a stock in the portfolio announce a deal and then promptly get clipped - except perhaps owning the target also and watching BOTH stocks go down. Such was the case when ambulatory health care IT provider Allscripts-Misys announced a merger with clinical health care IT provider Eclipsys. Allscripts-Misys nipped us for 66 basis points, but when you throw in Eclipsys' hit of 29 basis points the total was 95 basis points.

The deal makes a lot of sense. As hospitals acquire more and more physician practices, they want integrated IT solutions that address both the ambulatory and the clinical markets. Both Allscripts and Eclipsys are benefiting and will continue to benefit from demand generated by ARRA (the recovery act of 2009), which provides incentives to doctors and hospitals if they upgrade their IT. Better information will help the government manage health care costs.

So why the Street's toxic reaction? Well, let me quote CFO Bill Davis, who wrote in a letter to employees:

The reality is that our recent stock price decline has nothing to do with the fundamentals of our business and everything to do with the fact that in order for us to be able to complete the Eclipsys merger, we need to first help Misys plc reduce its ownership interest in Allscripts from 55% to approximately 8%. One of the keys steps associated with Misys plc's stake reduction is their

intention to sell at least 36 million shares they own to the public market...

Yup, nothing like a 36 million share overhang where the seller has named his price floor (\$16.50) to put pressure on a stock price. A more detailed discussion on why we think this is temporary follows in the portfolio section of the quarterly book.

In other news, we are going to celebrate our 15th anniversary this July 28. We feel undying gratitude to our first client, who put us in business, and who remains a client still. We thank you from the bottom of our hearts.

We also started a SMid product with house money on May 1. We are using the exact same process that we use in small-cap, but are merely expanding the market cap bull's-eye. There will be an overlap of no more than 12 holdings between the two portfolios, and these will of course be the larger (and more liquid) market cap stocks. As you know, our research-intensive style means that we have to follow many companies involved in the economic food chain around our holdings - many times these are too big for us to hold in the small-cap. We had been feeling frustrated for a while that we were not using every crumb of research insight to invest on behalf of our clients.

Our seasoned research team is excited and up to the challenge - each analyst is now covering an average of 13 stocks, up from nine - still a very manageable number. We are starting gingerly, wanting to make sure our

processes have a proper shakedown cruise, and that all systems are go. Even though it's only been two months, it feels comfortable. The proof will be found in the long-term performance of both products going forward.

We will work hard to have our future performance undergo a more pleasant metamorphosis, as we strive to keep the demons of regression to the mean at bay. We can't guarantee results, but we can guarantee that we'll put up a good fight. ●



Drawn October, 2008

Bic Mechanical Pencil and Sharpie Fine Point

By Octothorpopus (www.flickr.com/photos/octotho)

Art work based off Franz Kafka's "The Metamorphosis".