Second Quarter 2011 Portfolio Commentary

Crows, Penguins, A Perfect Storm and the Market

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Small-cap composite

As the crow flies, not much ground got covered in the market this quarter, with the Russell 2000 down 1.61%. Our small-cap composite trailed by 25 basis points, down 1.86%. This brings our year-to-date performance to 10.75%, versus 6.21% for the benchmark, for a lead of 454 basis points.

There was a lot of drama all quarter long, and all that fussing didn't make for a relaxing voyage. On the ground the journey felt a lot longer, full of ups and downs and twists and turns. The Russell 2000 peaked on April 29 at 865.29, bottomed on June 13 at 777.20, and then exited the last few days of the month with a rally, up 6.58%. We're pleased that our stocks did well in that run, giving us a 7.39% return. Our 81 basis point lead in the rally wasn't quite enough to help us completely close the gap with the benchmark by quarter-end, however.

Small-cap net impact of outliers

Our top three stocks generated 1.1% (Shutterfly, Cadence Design and Air Methods), and our worst three detracted 2.2% (MGIC Investment, Progress Software and Sotheby's), for a negative net contribution of our outliers of 1.1%. Though not a rare occurrence, it is infrequent, and not the kind of result we like to see from our outliers. The goal, after all, is to have our big winners overwhelm our big losers.

In the 62 quarters since 12/31/95, there have been 22 quarters (35% of the time) that our bottom three stocks outweighed our top three stocks. And in 18 of those quarters (82% of the time) the market was down as well, just like this one.

The net detraction has ranged from a teeny 1 basis point to a whopping 516 basis points (though to be fair, in that case the Russell was down 26%, so it wasn't only due to lunkheadedness on our part). Most of the time (17 out of 22 quarters or 77% of the time), the detraction was less than 200 basis points. In short, while undesirable, the existence and size of the net negative contribution from our outliers is well within normal.

Small-cap stock versus portfolio contribution

The good news was that the rest of the portfolio outperformed the Russell 2000, down only 70 basis points, boosting our relative performance by 91 basis points. Knowing that the bulk of the portfolio did better than the index tells us that the portfolio remains on solid footing, despite the slight lag in performance for the quarter. It also makes the case that our underperformance was more stock specific than not.

SMid-cap composite

> *When dumping bad news, tell it all, tell it first and tell it fast. Take full responsibility and apologize.*
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> – Nancy Schwartz

That's the best advice on communicating bad news given to Congressman Weiner that he didn't follow (and how!) during Weinergate. In contrast, the news about our second quarter's performance while neither salacious nor scandalous, does fall squarely under the definition of "bad." We were down 4.03% while the Russell 2500 logged in a mere 0.59% decline. And while we are up 3.70% for the year to date, we trail the benchmark's 8.06% return by 436 basis points.

We had three stocks that hurt us hard in the quarter, had no winners of consequence to offset the damage, and the rest of the portfolio, which we like to see earn its keep by beating the benchmark, failed to deliver. In short, the perfect portfolio storm of underperformance.

SMid-cap net impact of outliers

Our top three stocks (Cerner, MEDNAX and International Game Technology) contributed a total 79 basis points – while normal for a flattish market, nothing to write home about. Our worst stocks (MGIC Investment, Forest Oil and MEMC Electronic) cost us 300 basis points, just about evenly divided among the three. The net detraction of our outliers thus came out to 221 basis points, a number, in our experience, seen more often during markets that are flat-out bad. We can't blame the falling tide for this one. To quote Pogo, we have met the enemy and he is us.

That we take a 100 basis point hit in a position is not unusual. That we have a cluster of them happens less often, but is nevertheless an occupational hazard. And while the ultimate cause for each stock's decline is the same – existing holders vote with their feet and get out and would-be buyers are scarce and picky about price – the reasons for investor disappointment were different in each case.

Details on our SMid-Cap detractors

The biggest detractor to performance was private mortgage insurer MGIC Investment Corp. (MTG), which cost us 1.1% in performance. We knew at purchase that this holding would be volatile, dominated in the short-run by investors playing data point bingo as headlines on housing, employment and legislation hit the tape. The logjam resulting from the stand off between banks, servicers and insurers is beginning to ease with settlements being coughed up by the bad actors, market share is shifting away from the FHA and toward the private mortgage insurers, and insiders are buying the stock aggressively. There's tremendous value and earnings power in this misunderstood stock, but a cast-iron stomach is required, at least until the economic news becomes cheerier.

In the case of oil and gas producer Forest Oil (FST), we got hit with a double whammy. On the one hand we stubbornly insist that our Energy holdings run their businesses in a way that makes business common sense, i.e., only drill those properties where extracting hydrocarbons is profitable at near-term prices, rather than giving investors what they want: uneconomic production growth that is free cash flow negative to the company. Bad balance sheets and a need to raise capital at regular intervals to stay viable do not good companions make should a credit crunch arrive, so we like to steer clear of those, no matter how popular with the market. It reminds us of that old joke about the business man who is losing money on each widget sold, but plans to "make up the losses on volume."

While Forest Oil announced a shortfall relative to expectations in a well drilled in a play that remains promising, the Street has prematurely concluded that henceforth these lower production rates will hold true for every well drilled there. An overreaction, we believe. Also, for the next six months, the company is stepping up its drilling program but has taken production guidance down, which has reduced estimates for the back-half of the year. The production reduction is due largely to timing. Because Forest is spinning off its Canadian properties (which we expect to unlock value for shareholders), it has shifted its drilling priorities around, which has affected timing of production. We believe that as improved results flow through and as the spin-off becomes final at the end of September, investors will give Forest more credit where credit is due.

In contrast, we sold MEMC Electronic (WFR). While we concede that this maker of polysilicon logs, solar semiconductor wafers and developer of solar energy projects is very cheap, our investment thesis hopped the tracks. At such times we need to step back and reassess. We anticipated a decline in solar wafer prices in the back-half of 2011, which we were expecting WFR to be able to offset with lower manufacturing costs, thereby preserving margins. The decline was bigger and faster than expected, and the competitive landscape became extremely cloudy. We continue to monitor the company closely, as we think the business transformation that's afoot is worth paying attention to, but we've learned the hard way that some detours cause small delays in stock price performance, while others send you completely off course. Better to make sure your compass is working.

SMid-cap winners and losers evenly divided

Sixteen stocks were up and 16 were down for the quarter, as you'd expect from a flattish market. The difference was that the bottom half of the portfolio was heavier. (We much prefer a portfolio with top-heavy performance.) This can be seen in our best stock's (Health Care IT stock Cerner) anemic 32 basis points of contribution, while seven of our down stocks cost us 33 basis points or more. Most of these were not down for material fundamental reasons, however.

Sector contribution

Small-Cap Composite. Our sector weights weren't much help, as the defensive sectors were the place to be in the market this quarter. For the Russell 2000 Utilities

(+5.2%), Health Care (+3.7%) and Consumer Staples (+3.4%) were the big winners, while the biggest losers were Energy (-7.0%) and Technology (-4.4%). In our small-cap we own no Utilities, our Consumer Staples holdings (Chiquita and United Natural) were both down for the quarter, and though our Health Care stocks had slightly higher returns than the benchmark, we were slightly underweight, and so they weren't able to help.

In the small-cap our relative winning sectors were Consumer Discretionary, Materials & Processing and Technology, contributing 56, 55 and 53 basis points respectively in relative outperformance.

SMid-Cap Composite. Our sector exposures also did not help. Among best performing sectors in the Russell (Consumer Staples, Utilities, REITs) are sectors in which we have zero exposure in the SMid-cap product. As you know, we consider REITs a separate asset class due to tax code requirements that dictate their capital structure. From time to time we do invest in Utilities, but because their rates of return are regulated, find it difficult to find candidates that meet the "positive change in the rate of change in fundamentals" that is a central tenet of our stock in trade (pun intended). We've found nothing compelling in the Consumer Staples area, given valuations in conjunction with sharply rising input costs.

As for the other two sectors whose returns were up for the Russell 2500, Health Care and Consumer Discretionary (we are overweight both), we did not manage to beat the index. Every Health Care stock we own did much better than the index save for one — Community Health — and that was enough to matter. Although it's small consolation, the hit we took in Community Health came from left field. A company it was trying to acquire pulled out all the stops to prevent the acquisition and accused it of fraud. While we have confidence that Community is not an evildoer, these sorts of accusations take a long time to clear up and we chose to move on. We also sold Allscripts, a Health Care IT provider, which we continue to hold in the small-cap portfolio, in order to make room under the "no more than 12-stock overlap rule" for new idea Integrated Device Technology.

In consumer, the good news is that investors are warming up to our gaming stocks (Bally and International Game Technology) after several months of keeping them in the doghouse. Company-specific growth drivers are kicking in that are offsetting macro weakness, and this is helping the feel-good factor. However, our specialty retailers Urban Outfitters and Williams-Sonoma, as well as auction house Sotheby's, were down for the quarter, either due to macro fears or to investor confusion and impatience with evolving business models. In the case of Urban Outfitters and Williams-Sonoma, we are early in the lifecycle of those investment ideas, and investors will reward the stocks as the operational shifts we expect unfold. We continue to hold all three.

The market environment

The desire for safety can be seen in what worked for the Russell Indices in the second quarter, though year-to-date growth is still the "it" girl. The largest market caps, highest return companies, low beta, and dividend payers did best. The slowest growers did best in the quarter, though year-to-date the fastest growers have a commanding lead. The highest P/E stocks also are leading the way year to date, but the P/E picture was a mixed bag in the quarter, reflecting the crosscurrents that resulted in flat markets.

There was some flip-flopping between the "risk on" and "risk off" trade during the quarter, but in general, with this much squeamishness about the prospects for both the domestic and the global economy, never mind whole countries being declared insolvent and having their credit ratings put on watch (including the U.S.), the market was more focused on fear than fundamentals.

Supply, demand and psychology

Retail investors fled to the perceived safety of bonds. $4.7 billion in mutual fund outflows hit the small-cap space over the last two months, with another $1.7 billion leaving the leading Russell 2000 ETF (IWM). As a result, the latest American Association of Individual Investors survey indicates levels of bearishness that are bullish for the market (current levels of bearishness are close to March '09 and July/August '10 levels), and certainly corporate insiders became much more positive as we neared June's lows. Both augur well for a rebound.

Professional small-cap investors (at least those who responded to a Credit Suisse survey and as confirmed by eVestment data) indicated that they were taking a wait and see attitude, with slightly higher than normal cash levels, and lower position turnover, given the paucity of compelling ideas.

What to expect

Small and smid caps lagged large caps this quarter (the S&P 500 was up 0.1%), though both the Russell 2000 and Russell 2500 are beating the large-cap index year to date (R2000 6.2% versus 6.0% and R2500 8.1% versus 6.0%). The key will remain the difference in relative earnings growth rates. In aggregate, preannouncements have ticked up, and the growth rate in reported earnings is decelerating. When earnings expectations come in line with reality after a correction, a sustainable rally can be launched, provided that macro factors improve (or at least become more predictable). Small-cap earnings growth will drive performance.

The last recession was a hall pass for companies to take a machete to costs. Any management team hitherto too timid to take action found that their survival instincts kicked in and that, when the company's very survival was at stake, they had political cover to do even more than what was strictly necessary.

The big impact of cost reductions are behind us, and now inflation in raw materials is hitting right when the economy has gone from recovery to an expansion phase with shaky underpinnings, putting sales and profit growth at risk. Earnings growth rates have slowed down, which, in combination with the global macro environment, has made investors very skittish. How much to pay for earnings that are more dependent on factors outside of management's control? That is the question.

Penguins, icebergs and sharks

A market that's fixated more on growth than on price can look like a melting iceberg on top of which huddle a handful of expensive, fast-growing penguins. Every time one of those penguins misses earnings expectations, it gets shoved off the iceberg and becomes shark fodder. Late in the cycle we always have to get rid of expensive, fast-growing merchandise so as to avoid feeding the Wall Street sharks. The multiple compression that comes with a miss causes far more stock price damage than the actual earnings shortfall.

As we wait for a market where companies with better growth prospects are in aggregate cheap, we find value in stocks where investor psychology is most negative, and these often have stock prices driven more by sentiment than fundamentals. These also tend to be more volatile and unpredictable in the short run, but when investor psychology turns, returns are fat and booked quickly.

We continue to scour the investment landscape for good ideas. We've had a couple of works in process get snatched by acquirers before we could finish our due diligence, which adds to the frustration. Companies are deploying cash to buy growth, and we see that with the acceleration in mergers and acquisitions. The market is rewarding those companies deploying cash to pay down debt or to pay (or raise) a dividend. We are seeing the pace of announced buybacks accelerate, particularly among those companies most unloved by investors.

We are ready to pounce on new ideas this earnings season when expectations collide with reality, and as ever, we continue to stick to both our valuation and our sell disciplines. We've learned over the years that in these market environments, it pays to do so.

Firm Update
We currently have 71 clients and $1.9B in assets under management.