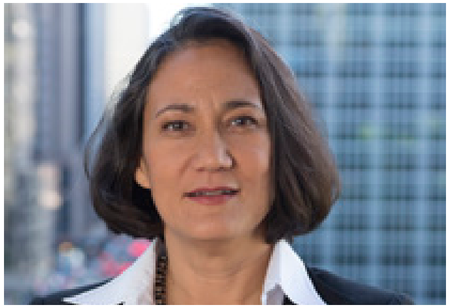
SMid-Cap Commentary

Paddling the Market Cross Currents



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Our SMid-Cap composite was down 10.80% versus -4.14% for the Russell 2500 in the second quarter, for a difference of 666 basis points. Given last quarter's head start relative to the benchmark of 156bps, such a reversal is frustrating beyond words. Year to date we are up 2.18% versus 8.31% for the Russell 2500, trailing by 613 basis points. Only 16% of SMid-Cap funds beat the index this quarter, and 11% are beating year to date. Despite having lots of company, we are not satisfied with underperforming.

Macro headlines (European debt crisis, slowing Chinese growth rates and weaker U.S. economic data) drove the market this quarter. Defensive stocks and those with no international exposure carried the day in April and May. Energy fell out of bed and health care was in limbo most of the quarter awaiting the SCOTUS ruling on the constitutionality of Obamacare. Companies with international exposure were shunned. The market then bounced back sharply in June, as European leaders stepped up efforts to resolve the debt crisis.

2Q Market Drivers

The second quarter felt like a mirror image of the first quarter, across the market cap spectrum. What worked for smaller companies in the first quarter (highly shorted, highly owned, no yield, high EMEA exposure) didn't work in the second quarter. This held true as well for large companies, where the biggest, highest yielding, least shorted, least well-owned, most U.S. centric stocks also worked this quarter, in a complete reversal for the first quarter's drivers.

Year to date, however, the smallest, lowest quality stocks are still winning the derby, as seen by the Russell Microcap Index, up a whopping 12.2% despite fears around Part III of the Great Financial Crisis. The lowest ROE and the non-earners are beating their high quality brethren as well. Aside from holding on to the gains made during "risk-on" market spells, the smallest companies may be in demand because they have less international exposure.

All of these market reversals make it hard to keep up. Correlations among stocks, while not at all-time highs, ticked up to 29.7%, higher than March's 24.8%.[1] More importantly, there was a real asymmetry in how earnings results were greeted: although beats were rewarded, the relative gains (+2.5% over 20 days) were much less pronounced than the relative price declines (-4.2% over 20 days) that accompanied earnings misses.[2]

1 BofA Merrill Lynch Second Quarter 2012 Performance Recap 02 July 2012
2 BofA Merrill Lynch Second Quarter 2012 Performance Recap 02 July 2012

Sector Performance

On a sector basis, our biggest positive contribution variations relative to the Russell 2500 were in producer durables (88 bps) and energy (67 bps) with technology (-461 bps) and consumer discretionary (-230 bps) the biggest laggards. In the case of producer durables, MAXIMUS (our biggest contributor in the quarter) and Regal-Beloit (electric motor manufacturer) drove our performance. As for energy, we were helped mostly by stock selection, with natural gas producer QEP down only 1.7% versus 12.9% for the Russell 2500 energy sector.

Top 3/Bottom 3 Performance

Our top three winners generated 183 basis points of performance, driven by MAXIMUS with 76 basis points, VeriSign (Internet domain name registration) with 58 bps and HealthSouth (inpatient rehabilitation services) adding 49 bps. Our top three losers cost us 443 basis points. We had four stocks cost us over 100 bps in the quarter: Riverbed (-160 bps), electronic programming guides maker Rovi (-153 bps), voice & video conferencing equipment company Polycom (-130 bps) and micro-controller supplier Atmel (-110 bps). These are all technology stocks. We continue to hold Riverbed and Rovi, and have sold Polycom and Atmel. We are returning to our tech roots by focusing on those businesses where we feel we can have a differentiated point of view and add value.

In addition, a new position, J.C. Penney (national department store) cost us 89 bps. In the case of JCP, while we made our first purchase after the stock retraced completely, the initial euphoria surrounding CEO Ron Johnson's ambitious turnaround plan had died down. We were clearly too early.

A complete transformation of the business, from merchandising, to shifting from a highly promotional to an everyday-low-price strategy, to taking out $900 million in costs (nearly twice the size of 2011's EBIT), does not unfold in a straight line. And while we had expected same-store sales results to be weak, we expected the announcement of new merchandising partners to confirm the turnaround plan was on track and to be well-received by investors. However, the shift in promotional strategy was not well communicated to consumers, and the new merchandise had yet to flow into the stores, resulting in same-store sales that were lower than we or the Street expected. This was made worse by an ill-timed dividend cut and an inventory reserve for old merchandise. JCP has already begun to fix its advertising message and the new product assortment will start to flow in late summer. We expect cost take-outs to drive earnings in the short term, until there's proof that the new merchandising and advertising resonate with the customer.

The net contribution of our top three winners and losers was a negative 260 basis points. The rest of the portfolio detracted an additional 820 basis points. Only 35% of the portfolio beat the index. A number of positions were down because of exposure to Europe and Asia, due to macro concerns rather than company-specific reasons. 38% of the portfolio's weighted average sales are derived from international sales.

We have continued to reposition the portfolio following Mort Simpson's departure in March. We have sold Assured Guaranty (financial guarantor), Dun & Bradstreet (commercial credit data services), Bally (gaming equipment manufacturer) and Hertz (car & equipment rental). Assured Guaranty has an excellent and aggressive management team and is trading at a significant discount to book value, but by the very nature of its business, it is levered and opaque. Dun & Bradstreet reported disappointing results and pushed back the timeline on its massive systems integration and architecture of its databases. We will continue to monitor the company's results for signs of progress. We sold Bally, one of the 12 stocks that overlapped with our Small-Cap portfolio in order to make room for Crocs (global casual footwear), as well as Hertz, whose complex, economically sensitive business model contributes more volatility to the portfolio than is desirable.

We added six new stocks to the portfolio: Avery (pressure-sensitive labeling), Crocs, Lam Research (semiconductor equipment), Gentex (automobile technology supplier), Sirona (dental equipment manufacturer) and J.C. Penney. Detailed write-ups follow. New names will continue to be added to the portfolio, and a couple of non-core positions with near-term upside drivers will be replaced as the year progresses.

Big Winner: MAXIMUS (MMS)

We bought MAXIMUS (Medicaid enrollment & outreach) in August 2010 at around $30 (split adjusted) per share. We believed the stock was undercovered and misunderstood. MAXIMUS is a government contractor and so was lumped in with defense companies and government IT services companies in terms of research coverage and valuation. But MAXIMUS focuses on business processes in very people-centered businesses, including welfare-to-work plans and helping people enroll in Medicaid and other government sponsored programs. These services were more specialized, and higher margin than the services of the companies MAXIMUS was being compared to. We believed it was only a matter of time before the Street realized the difference and saw MMS' compelling growth opportunities.

We discovered MAXIMUS after we owned Amerigroup (AGP), a Medicaid HMO, for a while. We owned Amerigroup for two reasons: 1) we saw many states moving more of their Medicaid and hard-to-serve populations to private Medicaid HMOs, and 2) we also believed that Amerigroup would be a major beneficiary of whatever form of health care reform emerged, either because Medicaid eligibility would be expanded, or because health insurance exchanges would be set up creating another market for AGP. We cast a wide net looking for other companies that would benefit from these trends. MAXIMUS is the leading provider of Medicaid outreach and enrollment services to states, and the company provides other services relating to state and federal health plans. The same trends that would benefit Amerigroup would benefit MAXIMUS, yet the Street hadn't caught on yet – the stock was not really known to health care investors. The more we learned about MAXIMUS' other business segment, its leading welfare-to-work business, the more we realized the company would benefit from the weak global macro environment.

The stock has been a good performer for the two years we have owned it, but it performed especially well this quarter for two reasons. The company is in the early stages of ramping up its new welfare-to-work contract in the United Kingdom. While the contract is initially dilutive to earnings, in year two and three (2013 and 2014) of the contract, the company should see a nice swing in profitability. When MAXIMUS reported first quarter earnings in May, management was able to provide some (though limited) visibility into the contract ramping as expected. While it

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The portfolio is actively managed, so holdings, sector weightings and other portfolio characteristics may have changed since the date shown. They should not be considered recommendations to buy or sell any security or of a particular allocation. You should not presume that any holding or allocation shown has been or will be profitable.

The appropriate comparison benchmark for the SMid-Cap Equity strategy is the Russell 2500. The Russell 2500 includes approximately 2500 of the smallest U.S. common stocks based on a combination of their market cap and current membership in the Russell 3000. The Russell 2500 Value Index includes those Russell 2500 Index companies with lower price-to-book ratios and lower forecasted growth values, while the Russell 2500 Growth Index includes those with higher-price-to-value ratios and higher forecasted growth values. The SMid-Cap Equity strategy is a concentrated strategy that is not managed to a benchmark, so there are material differences in characteristics, such as the number of holdings and sector and industry weightings. In addition, benchmark performance does not include any fees or expenses. Because of these differences, benchmarks should not be considered a completely accurate comparison.

Several charts are included in the book to demonstrate certain information or conclusions. You should not make any investment decision relying only on these charts.

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