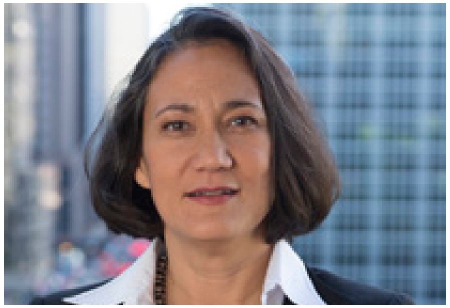
Small-Cap Commentary

Reversals and Rebounds



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Our Small-Cap composite lagged the Russell 2000 for the quarter by 166 basis points, down 5.13% versus 3.47%. We find some small solace that only 19% of Small-Cap core mutual funds outperformed this quarter, with the average fund being down 5.1%.[1] Year-to-date, our Small-Cap composite is up 7.05% versus 8.53% for the Russell 2000, trailing by 148 basis points. While there have been some notable highlights this year, we are frustrated that the steps we have taken have yet to translate into better performance.

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.

The market then bounced back sharply in June, as European leaders stepped up efforts to resolve the debt crisis. While we did not keep pace during the down months, we did exit the quarter on a positive note in June, both absolute and relative, as we were up 5.29% versus 4.99% for the benchmark.

2Q Market Drivers

The second quarter felt like a mirror image of the first quarter, across the market cap spectrum. What worked in the first quarter (highly shorted, highly owned, no yield, high EMEA exposure) in the case of the Russell 2000 didn't work in the second quarter. This held true as well in the case of the S&P 500, where the largest, 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. The Russell Microcap Index is up 12.2%, while the Russell 1000 and the S&P 500 are both up 8.3%. 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%.[2] 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.[3]

Sector Performance

On a sector basis, our biggest positive contribution variations relative to the benchmark were in energy (+105 bps) and producer durables (+124 bps) with technology (-276 bps) and health care (-92 bps) the biggest laggards. In the case of energy and producer durables, we were helped both by stock selection and by the industry exposures we held within the portfolio, which performed better than the sector as a whole. In the case of health care, one position (Allscripts) hurt, as did our lack of exposure to the biotech and pharmaceutical industries, which were the quarter's big drivers. In the case of technology, our variance was largely stock specific and self-inflicted.

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

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

Top 3/Bottom 3 Performance

Our top three winners generated 287 basis points of performance, driven largely by Lumber Liquidators (DIY hardwood flooring), up over 34% and contributing 140 basis points. MAXIMUS (Medicaid enrollment & outreach), and CoStar (real estate information services) delivered 77 and 70 basis points respectively.

Our top three losers detracted 315 basis points, with Rovi (electronic programming guides) costing 152 basis points, Vera Bradley (handbags & accessories) (90 bps) and Allscripts (IT solutions for health care) (73 bps). This meant that the net contribution from our biggest winners minus our biggest losers resulted in a drag of 28 basis points. The rest of the portfolio in aggregate detracted another 485 basis points, lagging the Russell 2000.

Big Winner: Lumber Liquidators (LL)

Lumber Liquidators is up 90% year to date, both because the U.S. housing market is growing anew and in part because the Street is coming around to our investment case -- one where margins can double and with continued top-line momentum can lead over time to earnings per share of $2 to $3, in contrast to last year's 94 cents.

We first bought Lumber Liquidators (LL) in December 2010. LL was a stock market darling that had put up remarkable growth despite the housing bust but had stumbled on an SAP implementation gone awry. We got in early and had to live through some disappointing results as the negative impact from the disruption caused by the new ERP system lingered longer than expected. In addition, the bump to sales from the first time homeowners tax credit in 2010 created a tougher than expected comparison in the spring of 2011, causing the company to miss earnings again.

These issues exacerbated the Street's skepticism about Lumber's market potential, given its atypical strategy of building a national presence first and then filling in existing markets. The opening of new stores in existing markets occurred during the recession. As a result, new store productivity was below that of prior years, fueling concerns that returns on capital would be permanently reset lower. In our experience, a recession merely pushes out the maturation curve of new stores, but investors are quick to fear that the lower new store productivity means the business model is broken.

We felt comfortable with the store cannibalization issue. Total sales in a market would grow, but more importantly, spreading the advertising and distribution/transportation expenses over multiple stores would more than offset the deleveraging that results from the temporary hit to same-store sales. Efficient transport is key, given the high costs of moving product from mill to store.

What got us even more excited, however, was the operational transformation the company was undergoing, one that we often see in formerly fast-growing Small-Cap stocks. It's rare that infrastructure growth and the adoption of robust business processes keep up with growth in sales. Just as replacing antiquated systems with SAP was long overdue, practically every business function, from how the company sourced its products to how store locations were chosen, needed to be revamped in order for Lumber to maximize its profitability now that it was considerably bigger.

All of the attributes listed above make Lumber Liquidators a classic "Daruma stock" -- a little patience on our part, a lot of misunderstanding and hyperfocus on one or two data points on the Street's part, and our conviction to add to a position that's down, derived from taking the time to understand the changes and opportunities at the company before their impact is seen in reported numbers.

As the stock has climbed, we have trimmed the position size above 5%. While we expect Lumber to deliver fundamentally, we continue to manage the position's size relative to valuation and to expectations. Lumber Liquidators still has considerable room to grow both top line and margins, and consumer sentiment around housing continues to improve as well.

Big Loser: Rovi (ROVI)

We've owned Rovi since 2006, and have added to and trimmed the position many times over the years. Back in 2008, when the stock was under a lot of pressure during the great financial crisis, we added substantially to our position.

In recessions, leveraged companies are shunned by the market. Rovi took on debt to acquire Gemstar from Rupert Murdoch. Gemstar included a horse racing and TV Guide channels, among other things, but owned valuable assets in TV program guides. Gemstar was a dog's breakfast of assets, and Rovi had to take the whole package and sell what wasn't strategic. The Street feared that the proceeds