A Rock Solid Quarter

By Mariko O. Gordon, CFA

We delivered good results in the third quarter, with our SMid-Cap composite up 7.60% versus 5.57% for the Russell 2500, for a lead of 203 basis points. Year to date the composite is up 9.96% versus 14.33% for the index, a lag of 437 basis points. We have made up some of the ground lost in the second quarter, and we continue to work hard on closing the gap.

The performance beat was a high quality one, as not only did we have a good contribution from the net of our top three and bottom three stocks, but the rest of the portfolio in aggregate beat the Index. In short, performance was generated across the portfolio, which is always preferable to having one or two stocks drive results.

Individual positions

Our best three stocks (WAN optimization vendor Riverbed +145 bps, Medicaid managed care provider AMERIGROUP +108 bps and dermatological & other drug marketer Valeant Pharmaceuticals +91 bps) contributed 344 basis points in total, whereas our three worst detractors (semiconductor equipment manufacturer Lam Research -57 bps, electronic programming guide maker Rovi -50 bps and automobile technology supplier Gentex -44 bps) in sum cost us 150 basis points. The net of our top 3/bottom 3 gave us 194 basis points, while the rest of the portfolio generated 566 basis points of performance.

We added five positions to the portfolio (direct marketing services company Acxiom, used car retailer CarMax, specialty materials supplier Celanese, OTC healthcare product supplier Perrigo and government health insurance administrator Wellcare), and sold two (AMERIGROUP, and radio frequency semiconductor supplier RF Micro Devices). We got an early boost in the quarter when Wellpoint announced its acquisition of AMERIGROUP at a 38% premium to prior close on July 9th. In the case of RF Micro Devices, a new product cycle and business restructuring weren't enough to overcome slowing global demand for handsets or the "back alley knife-fight" aspects of a hyper competitive industry.

Acxiom is a stock we've held in our Small-Cap portfolio since June of 2009. We are very encouraged by the steps new CEO Scott Howe and his team are taking to both enhance Acxiom's business model and to accelerate growth by bringing ACXM's formidable marketing databases and analytics wholly into the digital age. As is typical, though we've held the stock for a while, we continue to monitor progress closely. For instance, in one week we met with both the CEO and CFO at our offices and with their new Chief Product and Engineering Officer, Dr. Phil Mui, in Foster City, CA. "Dr. Phil," as he is known, joined the company from Google where he was product manager for Google Analytics, the world's leading analytics platform.

CarMax is a company we have been monitoring for over a year, making more than one on-site visit in the process. Because their business model is complex, which keeps valuation rangebound, we wanted to wait for the optimum entry point to meet our 50% upside hurdle, and we saw our chance this quarter.

Perrigo should continue to benefit from continued private label penetration at drugstores and mass merchants and from the conversion of pharmaceuticals from prescription to over the counter status. In the case of Celanese, we bought at a cyclical low point for their commodity chemical business, and at an inflection point for commercial adoption of a new technology that converts hydrocarbons into ethanol in a very cost-effective way. This gives us a good buy price, coupled with low expectations and a catalyst for growth. We bought Wellcare to replace AMERIGROUP, as it too will benefit from expected growth in medicaid enrollments.

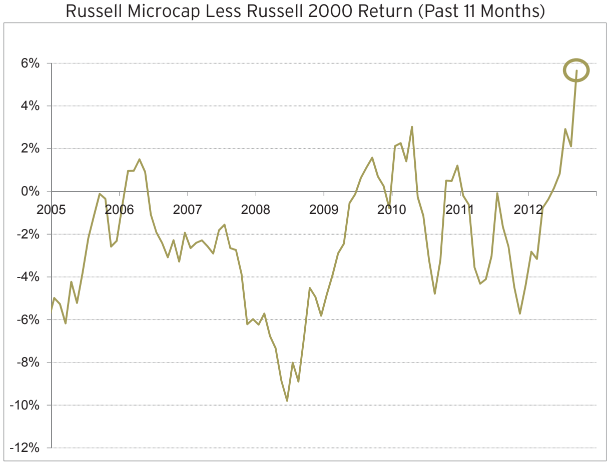
Sectors

From a sector point of view, our health care, producer durables, and technology exposures did well, contributing a relative gain of 241 bps, 147 bps and 121 bps respectively. Our worst performing sectors were materials and processing which cost us a relative 105 basis points, as well as consumer discretionary and financial services at 57 basis points each. Our sole financial stock, payment processor Wright Express did well, (+12.96%), so the difference in contribution was due to our underweight relative to the benchmark. That our consumer discretionary stocks did not do well, with only cruiseline operator Royal Caribbean outperforming, was uncharacteristic. Although automobile technology supplier Gentex and fine art auction house Sotheby's were both down a little, our lackluster results in this sector was largely due to lack of exposure in the industries that drove the index's consumer discretionary sector this quarter -- homebuilding, household furnishing, and media.

The Market

The quarter contained a number of market cross currents, which has been a hallmark of this year -- there's continued flip flopping between defense and offense, value and growth, quality and speculation, large and small. The Russell 2500 Value is beating Growth for the quarter (5.9% vs. 5.2%), and for the year (14.5% vs. 14.1%). The Russell 1000 was up 6.3% vs. 5.6% for the quarter, and 16.3% vs. 14.3% for the year versus Russell 2500. Interestingly, though Large-Cap is beating SMid-Cap year to date, the Russell Microcap index is beating them both, up 19.7%. For all the risk-on/risk-off vacillations, the smallest of the small have been the big winners.

Russell Microcap Less Russell 2000 Return (Past 11 Months)



Source: Furey Research Partners and FactSet; as of September 2012

Thus it's not surprising that only 2 out of 44 SMid-Cap core mutual funds are beating the index year to date.[1] Active managers typically hold higher quality and larger market caps than the index. This is tough to do when stocks with market caps of over $1 billion are the worst performing market cap segment, and the lowest ROE quintile stocks are the best performing, up 19.4%. Stocks that are losing money are up 25% year to date, way ahead of their profitable brethren, ranging from 17.5% for the lowest, to 16.3% for the highest p/e.

1 Credit Suisse Equity Research

Curiously, 48% of the Russell 2500 return was generated by the top five industries (real estate, software & services, pharma/biotech/life sciences, health care equipment & services and capital goods). Four out of five had below the median return on invested capital (ROIC) of 6.4% for the Index, but three out of five had among the higher earnings growth rates for the first half of 2012. This earnings growth may explain why the low ROIC industries performed so well, because over the long term, high ROIC companies outperform the low ROIC companies.

Russell 2500 YTD Contribution (as of 9/30/12)

Industry Group	YTD Contribution	Median ROIC	Median 1H12 Y/Y Earnings Growth	% Cos. w/ Pos. Y/Y Earnings Growth	R2500 Weight @ 6/30/12
Real Estate	+1.64%	2.6%	25.8%	63.2%	8.4%
Software & Services	+1.37%	6.4%	17.3%	67.7%	7.9%
Pharmaceuticals Biotechnology & Life Sciences	+1.32%	-34.4%	36.5%	48.9%	5.1%
Health Care Equipment & Services	+1.31%	4.6%	0.6%	54.4%	6.2%
Capital Goods	+1.23%	8.7%	7.7%	63.2%	9.6%
Consumer Durables & Apparel	+1.06%	8.5%	12.5%	71.2%	3.7%
Materials	+0.99%	9.1%	8.2%	60.2%	6.8%
Banks	+0.97%	4.1%	20.3%	76.0%	6.0%
Retailing	+0.87%	9.1%	12.5%	64.5%	4.4%
Insurance	+0.56%	4.4%	-3.5%	67.1%	4.6%
Diversified Financials	+0.47%	6.1%	12.7%	56.6%	3.3%
Utilities	+0.40%	6.1%	-4.3%	49.1%	5.2%
Consumer Services	+0.38%	7.5%	8.9%	61.4%	3.1%
Food Beverage & Tobacco	+0.36%	6.6%	6.2%	57.1%	1.8%
Telecommunication Services	+0.31%	6.3%	-14.6%	50.0%	1.3%
Media	+0.29%	7.3%	19.2%	62.8%	1.6%
Commercial & Professional Services	+0.29%	8.7%	13.1%	52.8%	3.4%
Transportation	+0.17%	8.1%	28.8%	79.5%	1.8%
Household & Personal Products	+0.10%	9.6%	14.9%	70.6%	0.7%
Technology Hardware & Equipment	+0.08%	6.8%	-10.3%	40.2%	4.5%
Energy	+0.07%	4.2%	30.8%	56.7%	6.1%
Semiconductors & Semiconductor Equipment	+0.06%	5.6%	-33.1%	20.2%	2.7%
Food & Staples Retailing	+0.02%	8.7%	1.0%	64.3%	0.6%
Automobiles & Components	-0.00%	10.7%	24.5%	48.0%	1.1%
Total	**+14.33%**	**6.4%**	**9.4%**	**59.1%**	**100.0%**

Source: Furey Research Partners and FactSet

Short interest continued to rise broadly even as the summer rally progressed. Typically in a rising market short interest decreases, so there has been a lot of skepticism associated with this market's rise. However, insiders have turned decidedly negative to levels normally predictive of weak markets, while sales and earnings growth have decelerated.[2] While the bar may have been reset lower for third quarter earnings expectations, it looks like fourth quarter and 2013 sales and earnings estimates may still be too high. This likely makes for a difficult market environment ahead.

One bright spot in the U.S. economy is the recovery in housing, which, though easily influenced by changes in consumer sentiment, has a huge multiplier effect on the economy. Should housing continue to recover, the U.S. economy may be in better shape than expected.

We are gearing up for what may turn out to be a very "interesting" earnings season and plan to take advantage of opportunities the market serves up. We have a robust new idea pipeline, and are very pleased with how smoothly analysts Daniel Doddo and April Zhu have been integrated into our research team and investment process.

2 Market Profile Theorems