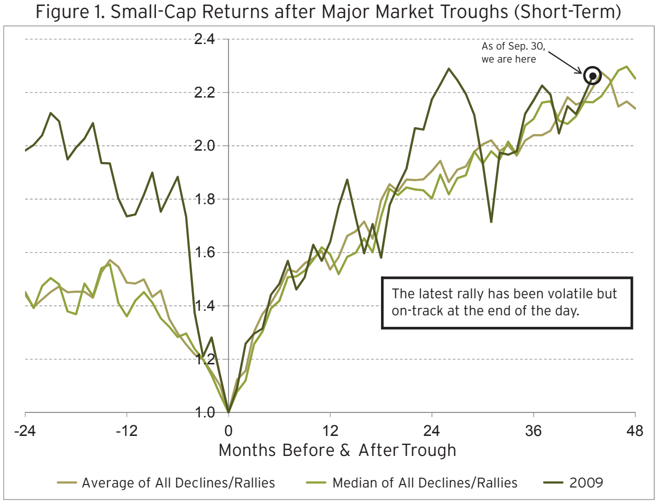
“It’s OK, It’s All Right, Stay in There and Fight-Fight-Fight!”

By Mariko O. Gordon, CFA

Both the third quarter and year to date results make us feel like we’re watching a high school basketball game, with the score tied and a quarter to go. For the quarter, our Small-Cap composite was up 6.00% versus 5.25% for the Russell 2000, ahead by 75 basis points. Year to date the composite is up 13.47% versus the Russell 2000’s 14.23%, trailing by 76 basis points. And while 2012 is proving to be less volatile than 2011, we are somewhat frustrated that on a relative basis we are not getting ahead, largely due not getting enough lift across the entire portfolio.

The top three contributors to performance were DIY hardwood flooring company Lumber Liquidators (+193 basis points), Medicaid managed care provider AMERIGROUP (+104 basis points) and direct marketing services company Acxiom (+71 basis points). Lumber was up 50% in the quarter, fueled by much better than expected second quarter earnings (up a whopping 126%). AMERIGROUP was up 38% due to the announced acquisition by Wellpoint. The total contribution by the top 3 winners was 3.68%. The bottom three (electronic programming guide maker Rovi -51 bps, telecom equipment supplier Ciena -46 bps and flooring and ceiling products maker Armstrong World Industries -25 bps) cost us total of 123 basis points in the quarter, leaving a net contribution from our outliers of 245 basis points, which is a healthy amount in a market that’s up a little over 5%.
The entire rest of the portfolio, however, contributed 355 basis points to performance and thus lagged the benchmark. As you know, we like to have a solid contribution from our best stocks, minimize our losers, but have the entire rest of the portfolio outperform as well.

Figure 1. Small-Cap Returns after Major Market Troughs (Short-Term)



Source: Furey Research Partners and FactSet

We sold five positions in the quarter, gaming equipment manufacturer Bally Technologies, helicopter medical transport company Air Methods, identification and safety products supplier Brady, electronics manufacturer Plexus, and on the very last day of the quarter, with the stock spiking over 20% on rumors of an LBO, health care IT solutions provider Allscripts. All five were positions where we either felt that risks were skewed to the downside, (Bally and Air Methods) or that the upside was no longer compelling enough to hold (Brady, Plexus and Allscripts).

We bought four new positions: auto dealer software maker DealerTrak, internet radio company Pandora, Medicaid health insurance provider Centene and specialty chemical supplier Shulman. With AMERIGROUP’s acquisition we added Centene, another Medicaid HMO that will benefit from the same favorable industry trends, as a replacement. DealerTrak is a company we've done a lot of work on over a long period of time, including several on site visits, in order to make sure that both the operational transformation was proceeding apace, and that we were on board with CEO Mark O'Neal's vision. Although Pandora may be controversial due to fears that the Apple juggernaut will offer music streaming, its business model is near an inflection point, and we expect them to reap the benefits of the investment they've made in their business over the last year.

We have not completed our Shulman position, (currently at 1%) as it is thin and we are being price sensitive. We expect to either have a full position or to take profits in the position we currently have by the end of the year.

Sectors

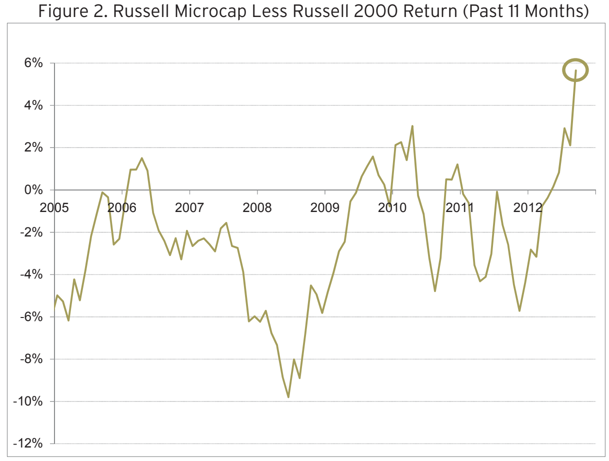
From a sector perspective, our best contribution came from consumer discretionary and health care (+170 and +82 basis points more than the index, respectively), which is not surprising given how well Lumber Liquidators and AMERIGROUP did in the quarter.

Materials and processing was the best performing sector in the Russell 2000, up 10.6% in the quarter with big moves in the most cyclical and commodity of the industries in that sector. We are slightly underweight and two of our stocks (Armstrong and Interface) were down a little, which, when combined with the lack of exposure to the "hot" industries, meant that we trailed on a sector relative basis by 108 basis points.

We were also not helped by our zero weight in utilities (-34 bps) and consumer staples (-4 bps) nor by our underweight in financial services, which mattered much more than our positive stock selection (-76 bps). Producer durables, technology and energy were all sectors that gave us a boost relative to the index, but in all, our industry exposures mattered more this quarter, and explains how the portfolio net of the big outliers had trouble beating the index.

The Market

Figure 2. Russell Microcap Less Russell 2000 Return (Past 11 Months)



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

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 2000 Value is beating Growth for the quarter (5.7% vs. 4.8%), and the year (14.4% vs. 14.1%). The Russell 1000 was up 6.3% vs. 5.3% for the quarter, and 16.3% vs. 14.2% for the year versus Russell 2000. Interestingly, though Large-Cap is beating Small-Cap year to date, the Russell Microcap index is beating them both, up 19.7%. Indeed, since the end of last October (market lows), Micro-Caps have outpaced Small-Caps by a stellar 6% (See Figure 2). For all the risk-on/risk-off vacillations in the market, the smallest of the small have been the big winners.

Thus it's not surprising that Small-Cap managers are struggling to beat the index year to date, with the average core Small-Cap fund lagging the Russell 2000 by 230 basis points.[1] Active managers typically hold higher quality and larger market caps than the index. In addition to size, there are other reasons the market has been tough to beat: for one, more than half of the Russell 2000 return (7.46%) has come from only the top five industries (real estate, pharma/biotech/life sciences, banks, software and services, and health care equipment and services). These industries have the lowest median return on invested capital (ROIC), but some of the best year over year earnings growth, and were severely underowned by small cap funds (See Figure 3). According to our friends at Furey Research, this is not typical of a low quality rally, where normally the contribution from low price, low market cap and low trading volume stocks is much higher -- the only low quality "tell" is low ROIC stocks, which have done well because of those rates of earnings growth. However, within those industry groups with low median ROIC, the best performing stocks were those with the highest ROIC. Over the long haul, the high ROIC stocks outperform the low ROIC companies.

Figure 3. Funds were underweight the top six contributing sectors by -11% in aggregate

Industry Group	1H12 Contribution	Contribution by Industry ROIC: Above Ind. Median	Contribution by Industry ROIC: Below Ind. Median	Median ROIC	Median 1H12 Y/Y Earnings Growth	% Cos. w/ Pos. Y/Y Earnings Growth	Avg. Fund OW/ UW 1H12	Avg. R2000 Weight
Pharmaceuticals Biotechnology & Life Sciences	+1.54%	+0.65%	+0.89%	-36.5%	36.5%	45.8%	-2.6%	6.2%
Real Estate	+1.37%	+0.88%	+0.50%	3.0%	20.4%	65.9%	-2.7%	6.8%
Software & Services	+0.92%	+0.36%	+0.56%	6.6%	17.6%	64.8%	-1.5%	9.4%
Banks	+0.91%	+0.43%	+0.48%	4.1%	19.4%	76.1%	-2.1%	7.8%
Health Care Equipment & Services	+0.70%	+0.47%	+0.23%	4.3%	0.0%	51.6%	-0.4%	6.5%
Consumer Services	+0.55%	+0.30%	+0.25%	7.5%	8.5%	61.1%	-1.2%	4.5%
Retailing	+0.52%	+0.35%	+0.18%	8.2%	12.5%	62.9%	2.1%	4.4%
Consumer Durables & Apparel	+0.43%	+0.11%	+0.32%	7.5%	8.9%	69.1%	0.5%	2.8%
Capital Goods	+0.37%	+0.17%	+0.20%	8.3%	8.4%	59.3%	3.8%	8.9%
Transportation	+0.27%	+0.12%	+0.15%	7.3%	28.8%	78.4%	-0.3%	2.7%
Materials	+0.24%	+0.19%	+0.05%	9.1%	12.4%	58.9%	0.9%	4.6%
Insurance	+0.22%	+0.13%	+0.09%	4.0%	-3.9%	58.7%	1.8%	2.6%
Food Beverage & Tobacco	+0.18%	+0.04%	+0.14%	6.5%	5.5%	60.7%	-1.1%	2.3%
Food & Staples Retailing	+0.17%	+0.11%	+0.06%	9.3%	5.5%	61.5%	-0.7%	1.2%
Media	+0.16%	+0.08%	+0.07%	7.4%	18.0%	65.6%	-0.3%	1.4%
Diversified Financials	+0.15%	+0.08%	+0.07%	5.2%	13.9%	61.2%	-1.0%	3.4%
Household & Personal Products	+0.15%	+0.05%	+0.10%	11.4%	14.9%	73.3%	-0.5%	0.7%
Commercial & Professional Services	+0.14%	+0.10%	+0.04%	8.7%	13.1%	51.4%	-0.3%	3.6%
Semiconductors & Semiconductor Equipment	+0.12%	+0.06%	+0.05%	9.5%	-33.1%	19.4%	0.7%	3.4%
Telecommunication Services	+0.06%	+0.07%	-0.01%	5.6%	1.5%	47.6%	0.1%	0.7%
Utilities	+0.04%	+0.04%	+0.00%	6.1%	-2.9%	41.2%	-0.7%	3.1%
Automobiles & Components	+0.03%	+0.02%	+0.01%	11.6%	24.5%	55.6%	-0.1%	0.9%
Technology Hardware & Equipment	-0.02%	+0.06%	-0.07%	7.7%	-8.8%	41.4%	1.4%	5.4%
Energy	-0.68%	-0.51%	-0.17%	2.3%	27.3%	53.5%	-0.9%	6.7%

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 estimates for sales and earnings 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.

1 Furey Research 3Q12 Quarter-End Letter

2 Market Profile Theorems