# Small- and Mid-Cap Core

### Third Quarter 2006
### Investment Update

The daily headlines in September chronicling the Dow Jones Industrials' determined march to its all time high, masked the underlying market turmoil that existed for most of the quarter and made it a difficult quarter for active managers to outperform their benchmarks. The market staged a tug-o-war between its beliefs that the Fed was finished raising rates because inflation was under control and a mid cycle correction was underway and the possibility that the economy was slowing much more than anticipated.

The quarter began with a severe down draft with the Russell 2000 and Russell Midcap Index down 7.3% and 5.3%, respectively in the first three weeks of July. They then moved steadily higher in August and September on the strength of financial and utility stocks. For the quarter, the Russell 2000 appreciated 0.44% while the Russell Midcap was up 2.11% and both trailed the S&P 500, which was up 5.67%. Within the Russell 2000, value outperformed growth and continues to hold a sizeable advantage for the first nine months of the year.

Commodities, particularly oil, drove much of the market moves as they continued their correction begun in 2Q. With minimal hurricane activity in the Gulf of Mexico, oil inventories were greater than expected while demand was perceived to be slowing more than expected. Oil prices reacted by declining from $77 early in July to a low of $60 in the last week of September. This drop translated into a noticeable decline in gasoline prices at the pump. The market quickly discounted this by selling energy stocks and buying the beneficiaries of lower energy prices, the consumer discretionary stocks, during the later half of the quarter. Technology stocks also moved higher as a high percentage of technology demand is driven by consumer end-uses.

**Small Cap Core:** During 3Q06, only four of eleven Russell 2000 sectors had negative returns: energy declined 10.3%, auto & transportation was down 9.1%, producer durables declined 2.4% and materials had a negative 1.6% return as investors reflected fears that the economy was slowing. All other sectors had positive returns. The Russell 2000 performance was led by utilities which rose 8.1% and REITs which were up 6.1%. Portfolio managers were defensive in their positioning seeking yields and staples.

Our 3Q outperformance was driven by stock selection. Our stock picks in technology, consumer discretionary, consumer staples and industrials all contributed positively relative to the Russell 2000. Underperformance relative to the benchmark occurred in energy and financials stocks.

**Mid Cap Core:** Only three of eleven sectors in the Russell Midcap index had negative returns for the third quarter. Energy was the worst performing sector with a 12.2% decline followed by auto & transportation which was down 2.2% and materials which had a negative 1.5% return.  All other sectors had positive returns.  The biggest positive contributors to the index were REITS which increased 9.5%, utilities which were up 6.6%, consumer staples which rose 5.8% and consumer discretionary which increased 3.5% as investors sought yields and staples.

On the positive side of the ledger, our 3Q performance was driven by stock selection in industrials and technology.  Underperformance relative to the benchmark occurred in materials, financials, energy and consumer discretionary stocks.

As we have mentioned previously we have used the market volatility over the last few months to upgrade the holdings in our portfolio.  We began to see the benefits of this process in August and September.  We believe the market will remain volatile throughout the September earnings release period.  We will continue our process of identifying investment opportunities that are attractively valued with a catalyst and a management team that can execute on the strategy.  It is these types of investments that have historically led the market out of periods of turmoil and we are confident that they will achieve superior returns over the next 12-18 month period.