

Small- and Mid-Cap Core

Third Quarter 2007 Investment Update

Third quarter stock market action will be remembered for a credit market crises, increased volatility, and the first Fed rate cut in over four years. The first half of the quarter was dominated by the escalating default rates in subprime mortgages and the impact it had on the credit markets. Credit markets froze with literally no buyers for mortgage backed securities. As the illiquidity in debt markets spread, funding for private equity deals came under pressure and some corporations were unable to access the commercial paper market. July and August once again illustrated just how interconnected global markets are today. With market participants attempting to reduce leverage and risk very quickly, quantitative funds found themselves positioned incorrectly for rapidly changing markets. They were forced to liquidate equity positions into a weak market. Weak equity markets brought more weakness as the forced liquidations from model portfolios gone awry triggered program trades that amplified already increased volatility. All sectors of the market saw elevated levels of volatility. Individual stocks were opening dramatically up or down but reversing course intraday to close equally dramatically in the opposite direction.

On the morning of August 17th the Fed cut the discount rate 50 basis points in an attempt to stabilize the credit markets. While its ultimate effectiveness in fixing an array of credit-related issues remains to be seen, the capital markets took solace that the Fed would be proactive. These actions created a floor for the equity market and stocks rallied through the close of the quarter as the Fed cut both the fed funds rate and the discount rate 50 basis points at their regularly scheduled meeting on September 18th.

The Russell 2000 and the Russell Midcap Index both declined over 11% for the quarter at their intraday lows on August 16th before rallying strongly to close the quarter down 3.1% and 0.4%, respectively. Small and mid cap stocks once again trailed the large cap S&P 500 index which was up 2.0%. Once again, growth outperformed value in the quarter in both the indexes and growth has a sizeable lead year-to-date.

Small Cap Core: This backdrop proved particularly difficult for our small cap core portfolios. We underperformed the Russell 2000 by more than 350 basis points.

Typically, our investment style has outperformed in a down market. There have been exceptions, of course, and this quarter was unfortunately one of them. The two exceptions occurred in the second quarter of 1998 when we trailed the benchmark in excess of 200 basis points and in the first quarter of 1999 when we trailed the benchmark by more than 600 basis points. The benchmarks declined -4.7% and -5.4% respectively in those periods. Both times we remained disciplined by adding to positions when we had conviction in the stock, and selling when we did not in order to improve the investment opportunities in the portfolio. This current period was no different. Having confidence in our investment

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process during difficult market periods has always resulted in a return to superior investment performance and we are committed to repeating that history. For the year, we remain ahead of our benchmark by more than 150 basis points.

For the September quarter, only two sectors had positive returns. Healthcare and technology were up 6.1% and 0.7%, respectively. Given the subprime mortgage crisis which continued to evolve throughout the quarter, it is not surprising that the two biggest negative contributors to Russell 2000 performance came from the consumer discretionary and financial services sectors which declined 8.8% and 4.0% respectively.

Most of our underperformance relative to the Russell 2000 occurred in our technology, financial services, consumer discretionary and autos and transportation stocks. Our stock picks in producer durables were our biggest positive contributor relative to the benchmark.

Mid Cap Core: For the quarter, we outperformed our benchmark by over 130 basis points and year-to-date we have exceeded the benchmark by more than 800 basis points.

For the September quarter, four sectors had positive returns. Energy (+5.0%), materials and processing (4.1%), technology (+4.1%) and healthcare (+3.6%) were the market leaders. Given the subprime mortgage crisis which continued to evolve throughout the quarter, it is not surprising that the two biggest negative contributors to Russell 2000 performance came from the consumer discretionary and financial services sectors which declined 4.1% and 5.0% respectively.

Our stock picks in financial services, health care, autos and transportation, and utilities all contributed positively relative to the Russell Midcap. Underperformance relative to the benchmark occurred in materials and processing, and energy sectors.

While the market seems to believe that the Fed can cut rates to contain the impact that housing and subprime mortgages have had on the economy, we remain concerned that the ramifications of the crisis could be deeper and have a longer tail than the market appreciates. That said, we continue to find a number of exciting investment opportunities and have been busy adding them to the portfolio recently. While the stocks we are adding to the portfolios are diverse companies, they all have in common the fact that they are attractively valued and have a near to intermediate term catalyst and a management team that we think can execute on their plan which we believe will cause the stock to move higher over the next 12 to 18 months.