Small- and Mid-Cap Core

Second Quarter 2008
Investment Update

A weak U.S. dollar, record high crude oil prices and another round of worry over how the credit crisis would play out led to a difficult finish for the second quarter across all major equity indices, and was a challenging backdrop for our portfolio. Crude oil prices surged almost 40% in the quarter setting an all time high of $145 per barrel. Gasoline prices at the pump rose above $4 a gallon just as the summer driving season began. Floods in the MidWest disrupted plantings and early crop development, which coupled with increasing worldwide demand, led to record agricultural commodity prices. Amid so many warning signs that consumer prices would accelerate, the Federal Reserve shifted its emphasis from lowering interest rates to spur faster economic growth to potentially raising rates to control inflation. The prospect of higher interest rates and the creeping suspicion that the large tax refund program was not enough to stimulate the economy in the face of higher food and energy prices sent the market into bear territory and back to its January and March lows.

The Russell 2000 peaked at its all time high on July 13, 2007 and has since declined by over 23% as of early July and the Russell Mid Cap Index peaked at its all time high on July 19, 2007 and has since declined by over 20% as of early July. The old saying goes that there is no such thing as an intellectual bottom, meaning the market is never as obvious or as analyzable as pundits suggest. We could come up with many markers that could signal the market bottom: a correction in crude oil prices which we believe have increased beyond supply and demand dynamics; a rally in the dollar; a bottom in the U.S. housing market; or maybe the consumer simply deciding that his or her job is safe and it's OK to spend. While any of these might put a bottom in U.S. equity markets, it is more likely that the low would occur while we wait for these signs to happen. The passage of time for investors to digest an onslaught of record-setting bad news, and valuation levels that discount that bad news, would end up being what marks the bottom for this bear market. We have seen markets like this before and we believe this one is close to a bottom. Why? Because we are finding so many stocks that are inexpensive by any historical metric and are discounting fears beyond economic probabilities. Attractive investment opportunities present themselves on a daily basis and we are working hard to choose the stocks with the best combination of value, catalyst and management.

Small Cap Core: In a market where much of what worked in the first quarter reversed in the second we underperformed the Russell 2000 by roughly 400 basis points for the quarter. For the first half of the year, we outperformed the index by about 300 basis points.

The Russell 2000 rallied over 4% in both April and May before giving most of the gain back by declining 7.7% in June. For the quarter, the Russell 2000 managed to stay in positive territory, up 0.58%. The second quarter saw a reversal of the first quarter as growth outperformed value by 800 basis points with the Russell 2000 Growth Index up 4.5% and the Russell 2000 Value Index declining by 3.5%. Energy and commodity stocks led the way while financial stocks were by far the worst performing stocks in the quarter. The energy sector of the Russell 2000 was up 47%. Materials & processing, up 8.2%, and technology, up 3.2%, were the other positive contributors to index performance. The biggest detractors were financial services, down 15.2%, consumer discretionary, down 5.7%, and auto & transportation, down 10.5%.

Most of our underperformance relative to the Russell 2000 occurred in our financial services stocks. Our stocks in materials and processing as well as technology also underperformed relative to the Russell 2000. Our stock picks in consumer discretionary and producer durables were our biggest positive contributor relative to the benchmark.

Mid Cap Core: In a market where much of what worked in the first quarter reversed in the second we underperformed the Russell Mid Cap Index by roughly 230 basis points for the quarter. For the first half of the year, we lagged the index by about 60 basis points.

The Russell Mid Cap Index rallied over 7% and 4% in April and May respectively before declining 8.0% in June. For the quarter, the Russell Mid Cap managed to stay in positive territory, up 2.7%. The second quarter saw a reversal of the first quarter as growth outperformed value by 458 basis points with the Russell Mid Cap Growth Index up 4.65% and the Russell Mid Cap Value Index up only 0.07%. Energy and commodity stocks led the way while financial stocks were by far the worst performing stocks in the quarter. The energy sector of the Russell Mid Cap was up 34.7%. Utilities, up 8.4% and materials & processing, up 7.6%, , were the other positive contributors to index performance. The biggest detractors were financial services, down 9.4%, consumer discretionary, down 7.3%, and REITs, down 5.5%.

Our stock picks in health care and consumer discretionary relative to the index led to most of our underperformance. Stock picks in technology and financial services relative to the Russell Mid Cap Index contributed positively to our performance.

Our view of the future at the end of this quarter is not that much different than it was last quarter. The economic and financial problems are not behind us, but we feel are being addressed. It can be a slow and painful process to resolve the underlying issues, but it must occur before the market can have a sustainable move upwards. Fear drives the market right now as evidenced by wild swings in stock prices both day-to-day and intraday. In the past, turmoil created by fear has resulted in attractive buying opportunities. This time should be no different. We are confident that our process will identify attractively valued stocks with clear catalysts and a management team that will execute a strategy to increase shareholder value.