

# Small- and Mid-Cap Core

---

## Third Quarter 2008 Investment Update

The third quarter began with crude oil prices at \$140 a barrel and the consensus viewpoint was that the global economy would remain strong despite the weakening U.S. economy. Stocks exposed to global growth such as energy, commodities and infrastructure plays were the darlings of the first half of the year while consumer and financial stocks underperformed substantially. Three months later, the U.S. dollar had rallied as the rest of the world came to grips with the spreading credit crisis, crude prices were under \$90 a barrel, the U.S. financial industry had been turned upside down by the bailouts or failures of Fannie Mae, Freddie Mac, Lehman Brothers, AIG, Washington Mutual and Wachovia, and the government negotiating the details of a \$700 billion rescue package for “toxic” loans. The credit market, once again, froze. Needless to say it was a particularly challenging time for investors across all asset classes. The Dow Jones had its biggest one day point drop on September 29th, the VIX index, which measures volatility, rose to levels not seen since the 1987 crash, and the stocks that worked in the first half underperformed dramatically in the third quarter.

**Small Cap Core:** Despite the tough environment, our portfolio was up over 6% for the quarter and outperformed the Russell 2000 by 700 basis points. For the year-to-date, we are ahead of our benchmark by over 1,000 basis points.

On a relative basis, small cap stocks fared well in the quarter. The Russell 2000 Index rose in both July and August before selling off roughly 8% in September. For the quarter the index closed down 1.1%. This compares with the S&P 500 which was down 8.4% and the Russell Mid Cap Index, down 12.9%. The Russell 2000 Value index actually rose 5% for the quarter and outperformed the Russell 2000 Growth Index by 1,200 basis points. For the year, the value index is down 5.4% compared to a 15.3% decline for the growth index. Sector contribution to Russell 2000 performance in 3Q was more or less the opposite of 2Q. Financial services led the way by appreciating 18.7% after declining 15.2% in 2Q while energy declined 35.6% in 3Q after rising 47% in 2Q. Other positive contributors to index performance were healthcare, up 8.3% and REITs which rose 5.1%. Other detractors were materials & processing, down 11.6% and technology which declined 5%.

Our stock picks in consumer discretionary, materials and processing, financial services and health care relative to the index led to most of our outperformance relative to the Russell 2000. Our stocks in autos and transportation as well as technology were our biggest detractors relative to the benchmark.

**Mid Cap Core:** In this tough environment, our portfolio trailed the Russell Mid Cap Index by less than 100 basis points. For the year-to-date, we are behind our benchmark by just over 100 basis points.

# Small- and Mid-Cap Core

---

On a relative basis, mid cap stocks were the worst performing sector of the market. The Russell Mid Cap Index was basically flat in July and August before selling off roughly 12.3% in September. For the quarter the index closed down 12.9%. This compares with the S&P 500 being down 8.4% and the Russell 2000 which was down only 1.1%. The Mid Cap Value index declined 7.5% for the quarter but outperformed the Russell Mid Cap Growth Index by over 1,000 basis points. For the year, the value index is down 15.5% compared to a 23.4% decline for the growth index. Sector contribution to Russell Mid Cap performance in 3Q was driven by REITs which were up 3.5%, consumer staples, up 2.8% and healthcare, +1.3%. Sector detractors were energy which declined 42.1%, technology which was down 17.7% and materials and processing, -20%.

Our stock picks in technology relative to the Russell Mid Cap Index led to most of our underperformance. Stock picks in materials and processing, energy and producer durables relative to the index contributed positively to our performance.

October has gotten off to an exceedingly difficult start for equity markets everywhere. Despite the best efforts of the governments around the world, credit markets remain very tight and the credit crisis is pressuring the global economy. Earnings expectations are too high and need to come down. As always, stocks are discounting a softer outlook ahead of analysts lowering their estimates. Layered on top of credit availability issues and a weakening economy is the fallout from hedge funds liquidating portfolios. September was a bad month for most investors but a horrendous month for many hedge funds. Bad performance has led to fund redemptions which in turn puts greater pressure on an already skittish market. Unfortunately, forced liquidations create irrational selling and even high quality stocks are hurt by the imbalance of sellers to buyers.

We have lived through dramatic equity market selloffs before and the bottoms are usually marked by irrational selling. Our approach to managing your portfolio will be no different this time: as dislocations occur, we will take advantage of them. Although we would prefer never to experience the pain of a bear market, we are prepared when one happens. The steeper the losses, the greater the opportunity created. We never doubt that the market will return to health and reward investors for their participation. Attractive valuations are being created daily, sometimes hourly, and rationality will be restored. We are here every day and will find stocks in companies with strong balance sheets, good long term business fundamentals, and managers who can execute.