

Institutional Small Cap Growth Strategy

2Q10

Market Review

Stocks took a hard spill during the second quarter of 2010 and the downward move of the Russell 2000 Growth Index effectively erased all gains from earlier this year. Investors had much to contend with this quarter after a year of unabated higher markets and economic recovery.

European debt concerns made headlines as open-ended economic aspirations collided savagely with the sharp market realities of budget deficits. At home, that same clash has played out in state legislatures and municipalities as governments contend with lagging tax revenues and budgetary pressures.

The European macroeconomic concerns dominated headlines, yet there were two high profile events in the U.S. that undermined domestic confidence. First, the massive Gulf of Mexico oil spill frayed trans-Atlantic nerves as BP PLC came under deserved pressure from political leaders in the U.S. to contain the damage and make adequate reparations. The legacy of the catastrophe – the technological needs of deepwater exploration, realistic contingencies, and the long-term cost of energy production and the environmental impact – remains ill-defined and under debate. Second, the U.S. equity market went through the unsettling “Flash Crash” of early May, during which the U.S. stock market experienced extreme intraday volatility.

Private sector job growth, so crucial to sustenance of the economic recovery, appears to have stalled in the past few months. While various indicators of U.S. economic demand remain positive, the rates of increase have slowed. Unemployment remains at disappointingly high levels.

Portfolio Highlights

Looking at our activity in the past quarter, we reallocated portfolio capital for the purposes of managing position size and risk, because fundamentals had taken an unexpected turn, or to establish new investments. We also reduced or eliminated a few positions which have moved above our target capitalization range, including Baidu Inc., AmerisourceBergen Corp., Citrix Systems Inc. and Urban Outfitters Inc. A number of positions were initiated during the second quarter such as J. Crew Group Inc., Monster Worldwide Inc., SVB Financial Group, Integrated Device Technology Inc. and Varian Semiconductor Equipment Associates Inc. or expanded such as Duff & Phelps Corp. and Jos. A Bank Clothiers Inc. We closed existing positions in AeroVironment Inc., Parker Drilling Co. and AmerisourceBergen Corp. during the period.

Relative to the benchmark Russell 2000 Growth Index, the Strategy’s overall stock selection detracted from performance for the quarter but overall sector allocation contributed to it. In particular, stock selection in the consumer discretionary and consumer staples sectors helped relative performance, while selection in the financials, industrials and health care sectors hurt relative performance. The Strategy’s cash position was the most significant positive factor in sector allocation.

The leading individual contributors to Strategy performance for the second quarter included Baidu Inc. (ADS) in the IT sector, Advance Auto Parts Inc. in the consumer discretionary sector, MercadoLibre Corp., in the IT sector,

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PORTFOLIO MANAGER COMMENTARY



Casey's General Stores Inc. in the consumer staples sector and Lions Gate Entertainment Corp. in the consumer discretionary sector. The bottom individual contributors to Strategy performance for the second quarter included Oceaneering International Inc. in the energy sector, Burger King Holdings Inc. in the consumer discretionary sector, LSI Corp. in the information technology sector, Affiliated Managers Group in the financials sector and Auxilium Pharmaceuticals in the health care sector.

Outlook

Whether the global economic recovery, which began in 2009, has been severely compromised (the "double dip" scenario) or merely tempered by domestic budget restriction and consumer saving behavior, and as a result of Europe's struggles and China's restraint, remains to be seen in coming months. Earnings expectations are in a "reset" period, moving from the heady operating leverage of early cyclical recovery to a less certain period, characterized by decelerating but still positive manufacturing gains and, conceivably, more measured earnings growth.

On the positive side, merger and acquisition activity remains active, with major strategic deals launched, indicating continued value in the eyes of acquirers. Debt financing is available at low nominal yields given the U.S. central bank's continued accommodative posture and benign inflation.

The equity rally in 2009 was all about anticipation of domestic and global recovery. The recent contraction of stocks has been caused by the difficult-to-gauge impact of austerity measures on global aggregate demand. While we expect decent near-term earnings growth, which can be an important mover of stocks, uncertainty about earnings faltering later in the year or into 2011 may overshadow the equity markets in coming months.

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