



## *Cortina Small Cap Growth Strategy 4<sup>th</sup> Quarter 2009 Commentary*

### **Our Ten Truisms of Investing**

The 2009 calendar year was as outstanding as 2008 was dreadful. We are not sure what to call those two years in aggregate — it was perhaps too short in duration and hyper-extreme in magnitude to appropriately call it a “cycle” — but for purposes of this discussion, we will refer to 2008/2009 as just that. The absolute level of return from our strategy likely seemed improbable as we entered 2009 and we certainly would not have been so bold as to predict it. We do, however, think it is valuable to analyze how this performance came to be as it gives tremendous insight into how this strategy is designed to work. Those intimately familiar with our strategy, and how it is executed, will understand the decisions we made throughout the cycle and understand why the 2009 results were so positive.

In a cycle like this, an investment philosophy and portfolio management process serve as the beacon to navigate incredibly rough waters. The philosophy and process have evolved into what they are today, having been shaped by experience. These valuable experiences include the rise and the bursting of the internet bubble, a recession, a prolonged economic cycle that drove prosperity globally and a bubble in energy stocks that sucked in many investors but which had a brutal and destructive end. Along the way, our experiences and observations have revealed investing truisms which have shaped our philosophy. These truisms helped guide us through the collapse in the housing market and the resulting credit crisis. We list ten (for no other reason than top ten lists are so very popular this time of year) which we hope will provide the reader with some insight into the many decisions we made, and thus the results we have accomplished.

#### ***1. Risk of Failure is a Function of Strategy, Execution and Financial Management – Not Company Size***

It frustrates us to hear the argument that small companies are risky and large companies are safe. This cycle saw plethora companies, big and small alike, fail. Lehman Brothers, Nortel Networks, and Lyondell Chemical are but a few of the one time large cap stalwarts that succumbed to bankruptcy during this cycle. Big company failures often open the door for small companies to thrive. Indeed, a small company only needs to pick up a fraction of the market share from a large competitor to really push its financial results. Crumbs can be quite relevant. We highlight two investments we made that are benefiting from meaningful supply reduction as a result of large competitor failures: 1) **hhGregg (HGG)** is an electronics

retailer currently operating 128 stores with aggressive expansion plans aimed at capturing a portion of the roughly \$7 billion of market share up for grabs post Circuit City's liquidation; and 2) **Evercore Partners (EVR)** is an investment banking boutique gaining access to larger deals following the exit of Bear Stearns, Lehman Brothers and Merrill Lynch. We also own a number of small, financially strong trucking companies that are circling the waters as one of the largest trucking companies teeters on the brink of bankruptcy.

## ***2. Innovation Can Drive Value Creation Even In A Challenging Economic Environment***

Good ideas know no cyclicalities. We acknowledge that in the short run, all investments can come under pressure. Yet we also passionately believe that the marketplace is always hungry for cheaper, better, faster products. We also believe that small companies are the source for the most dramatic innovation in a rapid economy. Our thematic approach to investing gives us an advantage in exploiting new innovation. In 2009, this was no better represented than in our commitment to the exciting new smartphone product category, which we exploited through a theme we call The Smartphone Revolution. Consumer electronic sales have been under pressure over the cycle and wireless handset sales declined 9% in 2009 according to Oppenheimer & Co. However, the category known as smartphones — put on the map by Apple's iPhone — grew 21%, and our portfolio took advantage of this growth in a variety of creative ways. At a recent meeting, the CEO of Best Buy summed it up best when he said, "Even in the teeth of this economic crisis we saw people lining up outside our stores for the latest smartphone". We continue to have our ear to the ground in search of the next great innovation.

## ***3. Keeping A "Wish List" Of Stocks Is Strategic***

As a team, we have researched a tremendous number of companies over the years. Each of us has a list of companies that we hold in high regard but for whatever reason (usually valuation or market cap restriction) we do not own them today. We believe it is imperative and advantageous to keep a "wish list" of these stocks that we might get a chance to buy on our terms should a rainy day (i.e., a severe market correction) occur. We got such a chance this cycle and took advantage in a number of cases including **Under Armour (UA)**, **Raymond James Financial (RJF)**, **FTI Consulting (FCN)**, and **Dick's Sporting Goods (DKS)**. Each is a terrific company that we thought we may never again get a chance to own as small cap investors, but fresh research and updated opinions provided us the opportunity to advantageously strike when overall market panic brought them into our wheelhouse.

## ***4. It Is Near Impossible To Time The Market***

When the market peaked on October 9, 2007, things felt terrific. When the market bottomed on March 9, 2009, things felt lousy. Our 2009 returns were not the result of making the "call of the century." In fact, there were differing opinions within Cortina on the market's prospects heading into 2009. We did not tactically exit and re-enter the market; indeed, those that tried, most likely either got out too early or back in too late. In contrast, we were rewarded for our conviction in what we believed to be excellent long-term growth companies as nine of our top ten contributors for 2009 were companies we owned heading into the year.

History has learned the hard lessons for us as empirical evidence shows that investors who miss the best days early in a recovery lose out on a meaningful portion of the gains in an up-cycle. We made many changes in our portfolio last winter, but they amounted to efforts on our part to cut deadwood and enhance the opportunities within the portfolio at large (see above).

### **5. Valuation Matters**

We are growth investors and not ashamed to admit it. We believe that especially in the small cap arena, over time, the most value is created by companies that are innovating, expanding and growing. That being said, momentum-only strategies perplex us. We will selectively accumulate stocks showing momentum if the fundamentals and valuation support purchase. However, many “momentum-only” investors were lost at the depths of the bear market and did not know how to ascertain a company’s worth because there was no momentum evident. This caused terrific companies to find levels that were absurdly cheap.

One such company we acquired was **BE Aerospace (BEAV)**, the leading supplier of cabin galleys and seats for commercial aircraft. The outlook for aircraft demand was no doubt very bleak in spring 2009 when we re-purchased the security (previously owned prior to spring 2008) though with the company trading at less than five times the prior peak earnings, the valuation seemed unsustainably low. With Boeing’s 787 *Dreamliner* slowly but surely progressing towards commercial sales, a new cycle looms on the horizon. We believe BE Aerospace is well positioned to earn more in the next cycle than it did in the prior cycle. Appreciating that value proposition near trough earnings has yielded lucrative returns for clients.

### **6. One Way Liquidity Is Very Powerful**

A principal factor in the depths of the market sell off was forced selling. When manager performance faded and investors demanded redemptions (primarily from hedge funds), selling pressure became incredible. Our affinity for small company stocks was no doubt a liability for a brief period of time. Too many investors crowding the exits at once during a buyers strike contributed to extreme downside volatility. We have always been aware of this risk but through the life of the strategy, two truths regarding this phenomenon have held: 1) These periods are short-lived; and 2) they provide opportunity on the other side, turning our market cap bias into an asset.

However, we must point out that we never try to time the conclusion of a liquidity freeze, for we have already established that we do not think timing the market is a winning strategy. Eventually companies which successfully execute attract the liquidity necessary to drive share price appreciation.

### **7. There Is No Need to Take Unnecessary Risks When the Entire Market Is On Sale**

Some managers display exorbitant returns in up years because they take imprudent risk near the bottom. We know this activity occurred and, as an example, saw it as investors

accumulated the stocks of undercapitalized financial institutions with the hope that the institution would pull a rabbit out of the hat and manage to survive. Many were rewarded handsomely for their boldness. That, however, has never been our style of investing. We do not take all-or-nothing bets with our clients' assets. Rather, when the market was getting annihilated, we did what we always do: trust our process, trust our research and invest in the best opportunities we could find. Now, we will not deny that our bias toward smaller companies benefited us after the market hit bottom....liquidity pressure works in both directions. Yet we made no conscious moves down the size or quality scale. We managed to improve our portfolio without sacrificing the high quality standards we demand. In fact, we came into this year with only nine of 93 portfolio holdings forecast to have negative earnings per share in the fiscal year. Of those, four were earlier-stage medical technology companies and three of them were hoteliers where reported earnings are often negative due to heavy levels of property depreciation. Moreover, with regards to size, our weighted average market cap appreciated relative to that of our benchmark index over this cycle. Our attribution analysis also shows the majority of our portfolio contribution for 2009 came from the larger market cap quintiles.

Where we differ from many other managers, however, is that we are willing to invest in small companies during periods of fear and stability. We do not invest in companies based on prevailing sentiment; we invest in them on the basis of diligent research, prudent analysis and supportable valuation.

#### ***8. Successful Strategies Require Consistent Execution Through Market Cycles***

As a team, we exited 2008 with mixed emotions on the year. From a returns standpoint, both absolute and relative, it was clearly a disappointing year for us. We often highlight our “no excuses” approach to investing and were not satisfied with the results. We were, however, incredibly proud of the way the team members went about our jobs on a day-to-day basis and continued to trust each other and execute the strategy. We did not stray from our quest for growth companies. We did not abandon the low end of the market cap spectrum where we believe the market is the least efficient. We did not chase hot sectors that were causing us angst. We used turmoil as an opportunity to create new investment themes. While many aspects of our philosophy and process were out of synch with market forces, because they had withstood previous market cycles we believed that consistent execution would pull us through this cycle as well.

Just as we stuck to our philosophy and process throughout the difficult 2008, we leaned even heavier upon it in 2009. Our success was driven by diversified themes and tireless research. Over the past year, Cortina investment professionals attended 88 conferences, held 1,124 company meetings and visited 24 states in the search for investment ideas. These face to face meetings helped us identify investments that would have been missed by a simple quantitative screening process. At the economic nadir, most companies screened poorly.

### ***9. Good Bottom Up Stock Selection Leads to Advantageous Sector Weights***

We have long said our sector weights are a function of stock selection and not a top-down macro call. We do not attempt to time the market, nor do we attempt to time individual sectors. If we focus on investing in quality growth companies, many with a thematic tailwind, that process should lead to profitable sector weights. We highlight Healthcare and Energy as two examples. Throughout much of 2008 we were significantly underweight Energy. At the time, we were uncomfortable with the exploration risk inherent in small cap energy companies. This was not a popular position to be in during the first half of the year when commodity prices soared. As horizontal drilling and hydraulic fracturing techniques advanced, drilling success rates increased dramatically in shale formations. The lower risk profile of shale exploration led to our Domestic Shale Energy theme and ultimately a sizable overweight in the Energy sector – one of the best performing sectors in 2009.

We entered 2009 overweight the Healthcare sector, which served us well in 2008. As the year progressed, we found ourselves selling several individual healthcare companies for fundamental or valuation reasons. An investment within our Minimally Invasive Healthcare theme was acquired at a nice premium and select holdings within our Healthcare IT theme reached extreme valuations. As these stocks were sold, much of the proceeds were reinvested in our Smartphone Revolution theme and other sectors, leading to a meaningfully underweight position in healthcare at the end of the year. This worked in our favor as Healthcare was a laggard sector in 2009. Our attribution analysis shows positive selection effect in each of the GICS economic sectors and positive allocation effect in all but one sector – we are convinced the former drives the latter, especially in small caps

### ***10. Knowledgeable and Informed Clients are Our Greatest Asset***

Investing based on what one thinks will look prudent and smart to an observer often results in straying from core investment tenets and ultimately poor decision making. At Cortina, we strive to maintain constructive and open dialogue with our clients and continuously remind them why we do what we do. We are proactive and transparent in our client communications in both good times and bad and make a sincere attempt to accurately account for short term performance volatility. Our clients know our process well because they take the time to read our monthly letter, scrutinize our decisions and ask probing questions in person and on conference calls. We are fortunate to have maintained the vast majority of our client base throughout an incredibly tumultuous environment.

2009 was by all measures a good year for Cortina. Perhaps the most important truism of investing, however, is that there is no finish line. We enter the New Year every bit as committed to our process as ever and will strive to maintain our commitment to informed client communication. We will make every effort to educate potential new clients on our philosophy and process that we believe has consistently worked over market cycles. Our best clients are those that believe in our process and are as committed to their research process as we are to ours.

## **Thematic Discussion**

As mentioned above, significant contribution to our investment results this year has come from successful exploitation of our themes. The theme construct helped us focus on segments of the economy that were poised to prosper once the period of extreme fear passed. Several of the themes we identified, and behind which we invested earlier in the year, are gaining high levels of press today, and we identify a few events during the fourth quarter that validate these trends in which we believe.

<u>Theme</u>	<u>Event</u>
Smartphone Revolution	It is reported that shortly after Christmas, iPhone sales are temporarily halted in New York City as a result of bandwidth strain on the network. This follows an effort by bloggers just ten days prior to jam AT&T's network to help convince it to expand its data capacity.
Shale Gas	In December, Exxon Mobil announces its intention to acquire XTO Energy for \$41 billion principally to gain access to its domestic oil and gas shale formations. This represents Exxon's most significant investment in U.S. acreage in decades.
Green Power / ABC: Anything But Crude	The 2009 United Nations Climate Change Conference is held in Copenhagen in December and is attended by an estimated 75,000 people. While tangible policy outcomes were limited, the summit itself reflects changing attitudes toward reliance on fossil fuels for energy.
Next Generation Communication Infrastructure	CommScore publishes a report revealing that internet subscribers watched 31 billion videos online in November and the average online viewer watched 732 minutes (12.2 hours).

## **2010 Economic Outlook**

Macroeconomic analysis today is easy to describe but difficult to draw conclusions from. The most meaningful and common exercises in this regard include some form of the following:

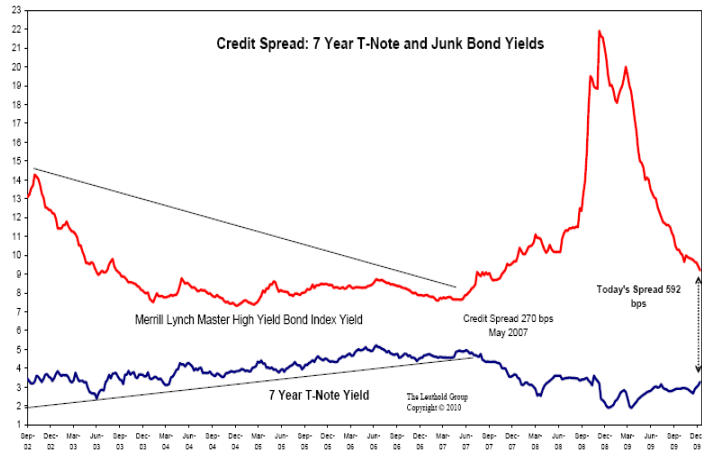
- Has risk subsided?
- How powerful will the stimulus dollars from the ARRA be when they are released to a greater degree in 2010?
- How and when will we pay for Federal indebtedness?
- What is the secular future of household financial leverage?
- When will housing and auto markets recover?
- When will the labor market improve so consumer confidence can improve?
- Has the stock market already come too far?
- How long will interest rate policy be accommodative and will fund flows return to the domestic market after the performance of "the lost decade?"

We know that this list is not all encompassing but we think these questions encapsulate a lot of the other minutia that fills a 24-hour news cycle and crams our morning email folders. Below we will briefly address each, supplemented with a few pictures; and the net conclusion is that things

look reasonably constructive, at least for 2010. The market is a fantastic discounting mechanism and no one can say for sure how much improvement has already been built in. We aim to understand the backdrop at large, rather than making hard predictions, because we do not believe our market outlook is what separates us from our peers.

Risk

We have long looked toward fixed income credit spreads as the barometer for how much risk the market at large has priced in. Higher credit spreads mean that investors are flocking to the traditionally safest vehicles (such as Treasuries) and abandoning lower-rated corporate debt. This chart shows we have almost returned to pre-credit crisis levels. Historically, low spread environments have been constructive for small cap equities.

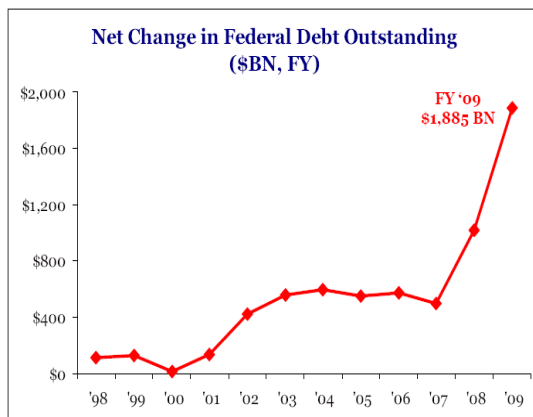


Stimulus Timing

The \$787 billion American Recovery and Reinvestment Act of 2009 signed early in the Presidency of Barack Obama has become incredibly politicized. Proponents say it has helped the economy bottom and opponents claim it has been ineffective. What is not debatable is that the schedule of funding will accelerate in 2010. We certainly expect this additional funding to stimulate demand within some industries but remain unsure of the ultimate multiplier effect it will have.

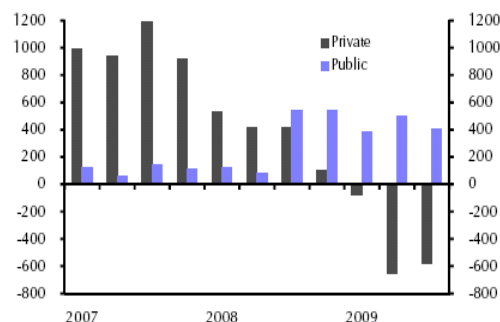
Federal Debt

Spending out of Washington and revenue pressure from a soft economy have inflated the U.S. Federal debt as the chart below from Strategas Research Partners shows. The U.S. Government has used its deep pockets and seemingly unlimited borrowing capacity to step in and transfer indebtedness from the private sector to itself as evidenced by the left chart below. We know that this phenomenon must someday be remedied by a combination of increased tax rates or less government spending and fear the unintended long-term consequence is higher interest rates and inflation. Yet as of now, given the trends in the market and the promising corporate profit cycle, these might be tomorrow's issues.



Source: Capital Economics

CHART 2: CHANGE IN PUBLIC & PRIVATE SECTOR DEBT (\$BN)



Source – Thomson Datastream

## Household Savings and Leverage

Over the last twenty years, households lived with more indebtedness relative to both their incomes and net worth. This was partially a function of the changing lending standards of financial institutions and partially a shift in consumer's attitudes toward debt. Behavioral



Source: The ISI Group

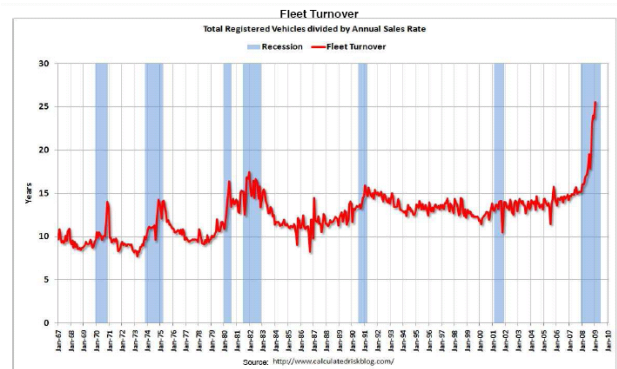
economics reveals that the generation that lived through the Depression assumed an attitude toward saving/borrowing that characterized their behavior for life. Over time, we will see if changes in the amount of debt consumers are willing to carry as well as their savings rate have been temporarily or permanently altered. If the current generation is structurally changed, household deleveraging will serve as a stiff headwind for years.

## Housing and Autos

Reviewing charts and graphs from before the recession with the benefit of hindsight, it is easy to spot outliers that should have served as a warning shot to all investors and economists. We have been looking for the same types of schematics that may cut the other way....suggesting that things have corrected too far on the conservative side. The two charts below may someday be referenced as marking the moment the housing and auto industries—two particularly crucial arenas today—recovered from extreme levels and helped spark an improvement in the overall economy.






Source: The ISI Group



Source: DealerTrack

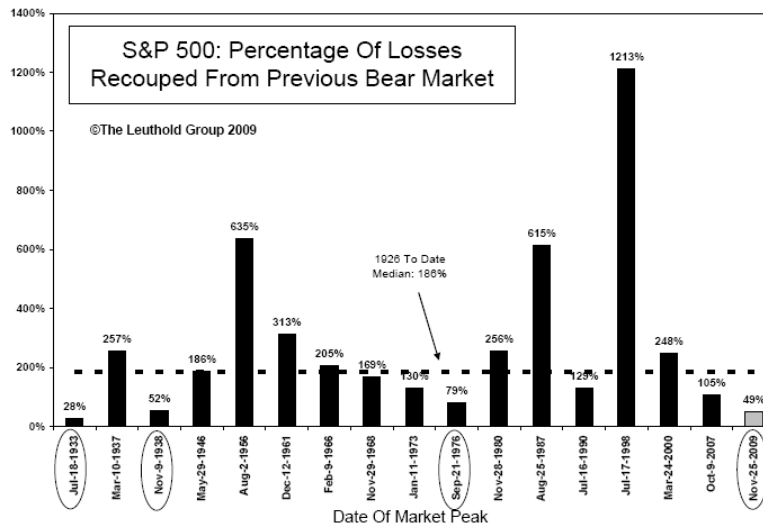
## The Labor Market

Despite the recent December jobs report, a closer look at all the data suggests the job market is bottoming. Quite simply, it is following a typical pattern featured on the following page. An improvement in the labor situation at large would go a long way toward the kind of sustained improvement in confidence that drives consumers to return to normal spending and investing levels.

Step 1: Cease firing	Step 2: Work staff harder	Step 3: Hire temps
 <p>Source: Department of Labor</p>	 <p>Source: The ISI Group</p>	 <p>Source: Robert W. Baird</p>
Source: Robert W. Baird	Source: The ISI Group	Source: Robert W. Baird

### Magnitude of the Current Rebound

It is easy to underestimate the ultimate extent of a post-bear market recovery. The 2009 bounce was incredibly robust but as the chart below indicates it is still well below that of the average recovery following the previous sixteen bear markets. This analysis fails to account for the duration each recovery required but it provides us with some valuable perspective.



Source: The Leuthold Group

### Interest Rates and Fund Flows

The market is beginning to price in expectations of rising interest rates. The yield spread between 2-year and 20-year treasuries has become very wide, and at 345 basis points, it is the highest it has been since 2003. While the Fed continues to offer a very accommodative policy with low short term rates; inflation concerns and a growing budget deficit are driving long term interest rates higher. Rate movement at the long end of the curve is often a harbinger of the eventual direction of short rates. While policy makers are in no hurry to choke off a recovery with a restrictive monetary policy, some of the rhetoric out of the Federal Reserve suggests higher targeted Fed Funds rates are on the horizon. As rates across the maturity spectrum

increase, bond prices, which move inversely with rates, are likely to fall. This could be a daunting reality for investors who have flocked to the perceived safety of fixed income securities. The data indicates this to be a fairly large crowd as fixed income funds enjoyed a record \$349 billion in net flows compared to \$12 billion in net withdrawals from equity funds.

We think this trend in fund flows could reverse in 2010. Investors are likely to be unpleasantly surprised to see the value of their bond funds diminish should rates rise. Likewise, strong equity returns in 2009 and the sound defense stocks provide against inflation could swing the pendulum back towards equity funds. Another potential source of equity fund flows could be commodities—in particular gold. Whether it is the perceived safety of hard assets or the inflation protection of precious metals, gold has become the latest en vogue investment. It seems you can't turn on the television or radio without being subjected to an advertisement for gold investing. We won't go so far as to say gold has reached bubble status, though we do view the recent gold rush with a healthy bit of skepticism.

Thank you for your interest in the Cortina Small Cap Growth Strategy.

Brian Bies, CFA  
Principal & Portfolio Manager

Steven Lilly, CFA  
Portfolio Manager

**Disclosures:**

1. The data provided about the portfolio characteristics relate to a representative account's portfolio holdings as of a single point in time. While we believe the data accurately reflect the investment process, the holdings and portfolio characteristics will change from time to time.
2. This package may include stock profiles, a list of top ten holdings and other information about portfolio holdings. Information about portfolio holdings is as of the date indicated and will change without notice. It is not intended to represent or predict portfolio investment performance or as a recommendation of any individual security. The specific securities identified do not represent all the securities purchased for accounts and you should not assume these securities are or were profitable.
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