



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

*4<sup>th</sup> Quarter in Review*

The drumbeat of change is upon the market, if not investors' minds. After a classical high-octane market bounce borne by economic recovery and greatly enjoyed by those once most impaired, the equity market machine is quietly shifting to the beat of a different drummer. The patina of beta is visibly wearing off. Of the few reliable plays from the stock market playbook, the transition from speculative issues to higher quality companies is unfolding. The sentiment of the market is palpable, the fundamental undercurrents lend credence to our thesis and the data reveal the maturation of the bear market recovery.

The two bear market recoveries compared on the right are *not* coincidentally from this decade. There's an unfortunate pattern at work here. Both recessions followed speculative bubbles (Internet and Housing) that were fueled by free money (IPO's and easy credit). In both cases, the Federal Reserve slashed rates to previously unimaginable levels once the wreckage revealed itself. For investors, 2003 and 2009 are mirror images in terms of springtime despair (fear) giving way to year end optimism (greed). Scorching small cap recoveries of 63% in 2003 and 84% in 2009 from each March low to year end are remarkable on many fronts. Most notable though, during both periods the market unmistakably shifted from the low priced, low market capitalization and/or money losing companies to the other side of the fence where profits are always greener. By the numbers on this chart, the leadership baton is now in new hands. Each of the three measures of quality reveals the exhausted effort by the beta-sprinters. In the same vein, we can further break down the small cap market in the fourth quarter by quintiles based upon market capitalization, stock price and ROE. Not surprising, in a monotonic fashion during the last quarter stock price performance moved in tandem with every higher quintile grouping in each of these metrics.

		Market Cap		
		< \$250m	≥ \$250m	Delta
2003	2Q03	43%	23%	+20%
	3Q03	13%	9%	+4%
	4Q03	17%	14%	+3%
	1Q04	4%	6%	-2%
2009	2Q09	53%	21%	+32%
	3Q09	23%	20%	+4%
	4Q09	-2%	3%	-5%

		Stock Price		
		< \$5.00	≥ \$5.00	Delta
2003	2Q03	66%	23%	+42%
	3Q03	25%	9%	+16%
	4Q03	18%	15%	+3%
	1Q04	7%	5%	+1%
2009	2Q09	66%	22%	+44%
	3Q09	41%	16%	+25%
	4Q09	-5%	2%	-8%

		Earnings		
		Loss Making	Profitable	Delta
2003	2Q03	50%	25%	+25%
	3Q03	16%	12%	+4%
	4Q03	14%	12%	+2%
	1Q04	6%	5%	+1%
2009	2Q09	51%	28%	+23%
	3Q09	28%	18%	+10%
	4Q09	-3%	3%	-6%

Source: Furey Research Partners

We would be greatly surprised to see a performance reversal in the New Year whereby excess performance boomerangs back to the smallest of the small caps. As 2003 served as a template for 2009, the same appears likely for 2004-2005 hinting at what may lie ahead for the next two years. As the economy shifts into mid-cycle growth, albeit at an uninspiring pace, investors should gravitate toward companies with consistently growing earnings and cash flow generation. Unit volume growth and pricing power should trump most plain-vanilla cyclical firms. Rising interest rates down the road, similar to 2004, should compress valuations and especially punish long-duration growth stocks with theoretical earnings far in the future. High levels of recurring revenues, rising operating margins and attractive valuations lie ahead for many businesses. These are the very types of companies that gained a generational attention from investors after the 2003 beta rally faded. Private equity firms served as the advocate for businesses with advantageously high and relatively stable cash flow attributes. Although private equity firms won't lead the charge this time around, we expect investors will wade back into the equity waters with these very types of stocks.

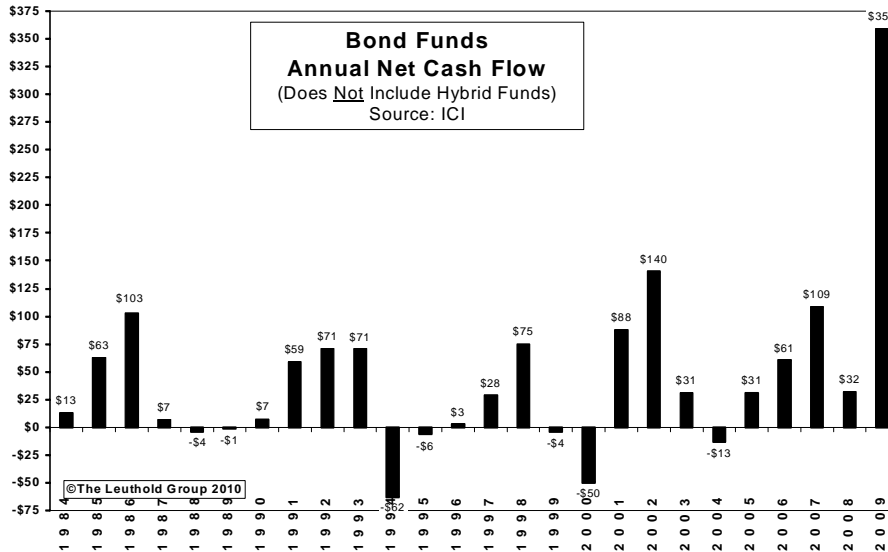
Nearly 10 years ago when our strategy took its shape we operated in a world of Morningstar "value" and "growth" boxes. Frankly, the marketplace really didn't care much about small cap strategies geared toward the compounding advantage of cash flow supremacy. Not until after 2003, that is. At some unknown point five or six years ago, many investors finally demanded a higher standard for their money – one that shunned tech stocks bogged down by profitless prosperity. Small cap blue-chips gained investor attention. Today, we find the parallels to the last economic recovery similar along these same lines. Investors are dusting themselves off from another asset bubble (housing) and another too good to be true investment craze (hedge funds). In past quarterly letters we've walked through our Darwinian expectation for a multi-year period of company warfare. Predator versus prey, the weakest companies without affordable capital simply won't fund acceptable levels of working capital, R&D spending, sales force growth, capital project expenditures, etc...

Successfully navigating the market in 2009 (without sacrificing our investment discipline) positions the portfolio well for the foreseeable future. There is no change in our roadmap, although there is an emerging inflation wildcard to watch. Destructive to some, inflation presents additional opportunities for franchise companies to flex their competitive muscles. We'll address our strategy for managing in an inflationary environment later in this letter.

### ***Is Not Winning a Winning Strategy?***

The battle between fear and greed never ebbs inside an investor's psyche. The pain of losing a dollar far outweighs the joy of winning a dollar. And so it fuels today's reckless drive by investors to defensively retrench with bonds, bonds and more bonds. In what should go down in history as another asset bubble with high hopes and little return, bond funds hauled in nearly \$360 billion in 2009. That's 11 times last year's tally during the market collapse and nearly five times the typical \$75 billion inflow. Said differently,

2009 bond fund inflows as a percent of all assets under management spiked to a 3-standard deviation upside event over the past ten years. Investors are obviously so frightened by the stock market that the bond market not only captured traditionally defensive investment dollars but also dollars that should demand capital appreciation. While the flow into high yielding corporate bonds was stronger than government bonds,



Source: Leuthold Group

make no mistake that investors hid in bonds while extracting nearly \$40 billion in equity mutual funds 2009. Haven't we seen this movie before?

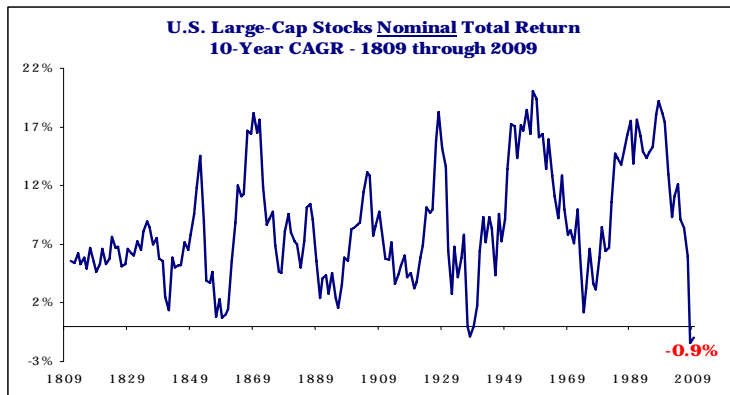
Fearful investors locking in a certain, miniscule (or likely negative) real return ironically benefited everyone else instead. First, the biggest credit bull market in history (according to WJB Capital) has temporarily cured the credit crunch. High yield junk bond spreads have plummeted back down to December 2007 levels. The lemmings that stampeded into bonds to satisfy their quest for certainty fueled enormous stock market gains for others. Bond investors carried the water; equity investors drank from the cup. Scarce credit became easy credit. Ironically, the very same safety-seeking fixed income investors are the ones providing the asinine “amend, extend and pretend” refi funding wave that will come home to roost someday. Second, the government enjoyed multiple benefits along the way – fearful investors not only pressed borrowing costs lower for businesses and individuals, but also for Uncle Sam. With a newfound interest in saving part of one’s paycheck, individuals are picking up where the fatigued Chinese buyers of US Treasuries are leaving off. Washington is eagerly rolling over our national debt at lower rates and at longer maturities. Lastly, don’t bond investors realize they’re participating in a bubble of perceived safety and it is 24 months too late? Willingly accepting a negative real return (i.e., after inflation) in a fixed income product that will surely face capital depreciation when interest rates rise in 2010 or 2011 simply confounds us. Are the lessons from 1994’s sudden interest rate hikes lost on the market?

Moving forward, the bond market will certainly affect equity investors. Bond flows should taper off as money market and bond investors appreciate the portfolio numbing affect of negative real returns and/or capital depreciation. Out of necessity, anyone

hoarding cash and short term fixed income instruments will succumb to the government's curse on cash. Understandably, Washington wants idle capital put to productive use – or at least thrown against the wall to see what sticks. Yes, buying stocks or real estate is considered productive by Washington standards if a price recovery jump starts a positive feedback loop of confidence, investing, spending, more confidence, etc... If politicians are willing to transfer trillions of dollars of private debt onto the public books while also spending money they don't have, then idle private cash will be taxed by inflation. At some point down the road, fixed income investors will be forced to participate again in capital appreciation instruments such as equities. With too few attractive asset classes to satisfy all of the world's wealth, we expect a return by once scorned equity investors. They will defensively flee from safety during rising rates only to offensively seek stocks for their inflation-hedging attributes.

### *Seeking Real Returns amid Silent Wealth Confiscation*

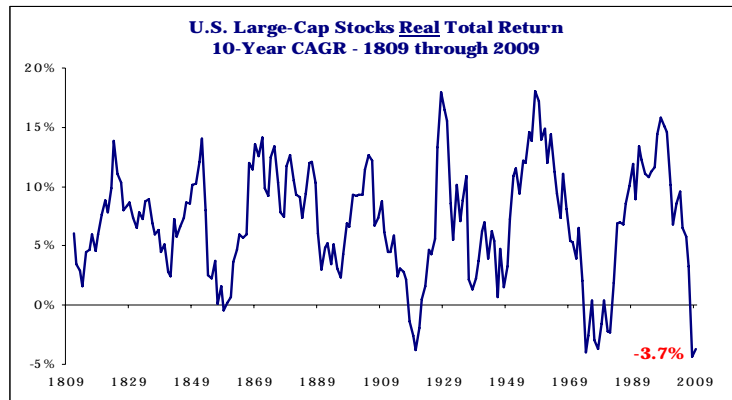
For investors who found opportunity in equities in 2009, there's still a bond-like phenomena to worry about – earning an adequate real rate of return in addition to fighting the likely effect of lower P/E multiples when rates rise. Equity investors mustn't ignore the deleterious effect of stable or rising inflation on their portfolio. In a period with such excess capacity across many industries – and thoughts of a deflationary death spiral arose only nine months ago – contemplating an inflationary environment may seem out of left field. That said, the following two charts illustrate the destructive force of inflation during the historically typical inflationary environment since 2000.



Source: Strategas

The chart to the left represents the trailing 10 year compound annual returns for domestic large cap stocks for the past 200 years. Only once before, during the Great Depression, did investors realize a negative *nominal* return over a ten year period.

The chart to the right adjusts for inflation with *real* returns. If the destructive impact of recently tame inflation doesn't startle you, then imagine losing almost 3% of your wealth every year just because you possess it.



Source: Strategas

While large cap bulls like the potential reversion-to-the-mean of the S&P 500, we're not advocating large cap stocks with these illustrations. We're first making the point that normal inflation must be respected and accounted for by investors as an ever present depressant on wealth and one's standard of living. Above that, offensively countering inflation will be paramount in the years to come. Hence our admonishment of investors hiding in "safe" fixed income investments on the eve of higher interest rates meant to ward off inflation, thus depreciating their bond portfolio in the process.

As a longtime client often reminds us, it's not the car next to you on the highway that threatens you, but rather the oncoming car that suddenly jumps the median. Put into investment terms, the nearby deflationary vehicles of high unemployment, slack capacity and low wage growth are fully known and understood by the marketplace. It's what everyone knows and the market has discounted. But because it's easier to point to yesterday's reported deflationary statistics than estimate tomorrow's inflationary pressures, individuals fall prey to status quo assumptions. The market, however, acts alone and is now discounting rising rates. The 10-year Treasury bond rose 64 bps in December alone.

But what about the incalculable risk of rampant inflation due to untiring currency printing machines around the world? According to the highly respected economic strategists at ISI, we're in uncharted waters. Across the globe since August 2008, there have been 787 monetary and fiscal policy initiatives taken to jump start world GDP. Interestingly, the Treasury Department is quietly ramping up issuance amounts of TIPS (Treasury Inflation-Protected Securities) because foreign governments are now demanding an inflation hedge on money lent to us. Instead of guessing the magnitude and duration of the stimulus aftershocks, the TIPS market and foreign buyers of our IOU's are showing newfound concerns about inflation and rising interest rates.

Without predicting how inflation sneaks into our lives – wages, food and energy costs, rent – we're simply doing several things. First, we're closely watching the market's discounting mechanism for early indications of inflationary problems not yet in the numbers. Considering Ben Bernanke is a student of the Great Depression and can fight

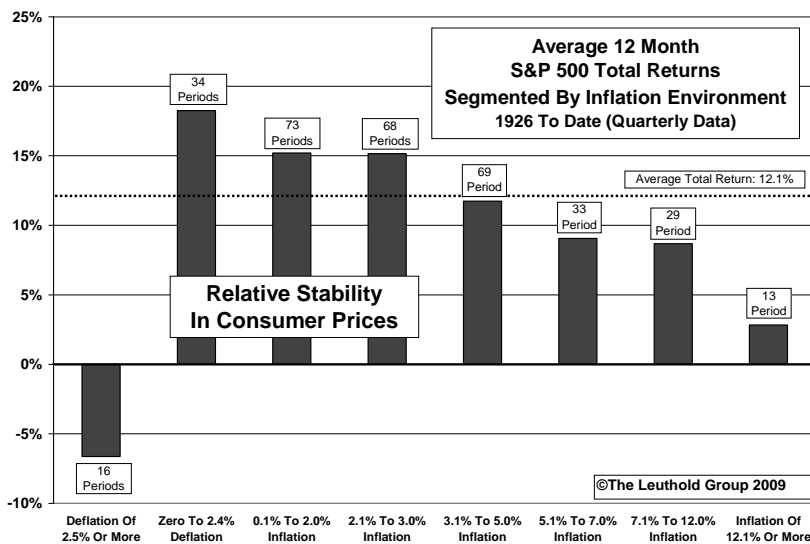
inflation much easier than deflation, a dose of common sense suggests the entire punch bowl (here or abroad) won't be taken away until it's too late. Second, we're monitoring direct and indirect government policies aimed at wealth redistribution. Since inflation is nothing more than the legislated confiscation of one's wealth over time, it's an effective tool to rebalance society's balance sheet. Debtors (consumers and the US Government) should enjoy a reduction in their indebtedness as dollar-linked debt diminishes in relative value during inflationary times. Creditors (lenders) and Savers (fixed income investors) should conversely suffer as their dollars lose value.

*“As the supply of money (of claims) increases relative to the supply of tangible assets in the economy, prices must eventually rise. Thus the earnings saved by the productive members of the society lose value in terms of goods... Deficit spending is simply a scheme for the ‘hidden’ confiscation of wealth.”*

Alan Greenspan, *Gold and Economic Freedom*, 1966

### Stock Market Performance & Inflation

In brief, equities not only do fine during most bouts with inflation but they can also serve as one of the few positive real returning asset classes for investors. The chart below illustrates the nominal quarterly performance of equities during various inflationary settings since 1926. The primary conclusion is that deflation in excess of 2.5% is highly destructive to equity portfolios (as feared in March 2009), while inflation greater than 7% also fosters negative real returns. Although these statistics are not discussed at the dinner table, we expect



Source: Leuthold Group

households currently hiding in bonds and money market funds will shift to equities as they realize the capital preservation function equities can serve going forward. Surely an unpleasant feeling, but asset allocation by professionals and individuals to offensive-minded equities for defensive preservation purposes may result. The

swinging pendulum never pauses for long and we think investors ought to focus on the inflation wildcard. If the government's curse on cash hasn't moved enough idle capital toward productive use yet, then the threat of rising inflation will. Identifying companies that can not only prosper during normal times, but also thrive during inflationary spikes is critical.

### *Prospering Amid Rising Inflation – Franchise Companies*

We stand by our 2009 thesis that access to capital will further separate the haves and have-nots in the small cap arena. Too many marginal companies have been built over the past two decades that otherwise wouldn't have seen the light of day had capital market participants charged the appropriate financing rate. There's no reason in a post-credit bubble environment that as many untested businesses should get their chance at success with essentially free credit. Similar to what the energy exploration companies surprisingly witnessed approximately ten years ago, the typical buyers of secondary offerings simply said "No" to endless capital raises that yielded crummy results. This phenomenon occurs every few years in a few industries when enough investors realize they've been suckered for too long. When they stop feeding at the capital markets trough, the cost of capital soars for these companies; many face diminished opportunities or bankruptcy when the capital spigot is turned off.

Today's current topic of rising inflation, likely first through food and energy costs and then through cost of living adjustment wage changes, should further divide the weak from the strong. Inasmuch as the credit crunch didn't extinguish nearly as many companies as expected, the secondary effects are rising on the horizon. Those companies hanging on for dear life certainly reduced their working capital and deferred capital expenditures to reduce cash burn. Reinvestment in the business to maintain core strength likely fell by the wayside to avoid tapping lines of credit. Workers were cut and plants idled or scrapped to preserve cash. Flexibility and preparedness for the cyclical upturn were luxuries not necessary during the darkest days of late 2008 and 2009. As a result, countless companies that have so far survived are really just hollow shells of their former selves. Without adequate access to capital they won't fully participate in the economic rebound. Any company unable to fund their working capital needs, capital expenditure plans, job training programs and sales force recruitment expenses will be at the mercy of the markets. Nimble companies without debt should eat their enemies' lunch. We're seeing it firsthand across many industries – debt covenant restrictions limiting a company's ability to do it all over again.

The inflation wildcard may very well be the knockout punch we didn't yet think about last year. Rising operating costs (energy, rent, utilities and labor) could erode profit margins for those with inflexible manufacturing models. Renting instead of owning could backfire on those who couldn't even afford to purchase their plant, property and/or equipment when times were good. Rising construction costs due to material and labor inflation (as implausible as that may seem) would punish companies that deferred plant maintenance and/or expansion during the credit crunch. Rising interest costs certainly punish those with variable long term debt, whereby the LIBOR rate matters as much as the premium charged above LIBOR.

Our investment approach has always stressed the importance of companies with increasing unit sales, pricing power, efficient production processes and wise capital

discipline. During inflationary periods, these attributes wouldn't just be the typical envy of other's – they'd actually separate winners from losers. Our research team always searches for companies that can leverage their existing infrastructure by increasing unit volumes more so than the associated costs of production and sales. In an inflationary environment, rising volumes and a modicum of pricing power goes a long way. Unit and pricing gains are crucial for offsetting cost pressures. At the end of the day, companies are either better or worse off in an inflationary environment. There's little middle-ground

for debate. The least we can do as prudent investors is to consciously limit your exposure to industries that are structurally flawed. Industries facing recurring deflationary pressures typically face low barriers to entry, excess capacity, limited capital discipline by participants and price as the ultimate weapon for market share growth (in the beginning) and then retention (near the end).

### Year-over-Year Changes in CPI

#### "Things You Need"

Gasoline	23.6%
Transportation	8.8%
Hospital	7.1%
Education	4.8%
Medical care services	3.5%

#### "Things You Want"

Recreation	-0.2%
Video and audio	-1.6%
Household furnishings	-1.0%
IT, Hardware and services	-4.1%
Personal computers	-12.3%

*Source: Strategas (Nov 2009 data)*

The chart above illustrates the critical difference between companies as price takers and price setters. If companies can't hold the line on their Average Selling Price (ASP), then making it up in volume becomes defensive revenue management. More times than not, the required exponential rise in volume does not occur. That said, companies with pricing power aren't necessarily on Easy Street – their cost of goods might be rising even faster than revenues! As such, our strategy places great emphasis on realized gross margins (i.e., Revenues minus Cost of Goods Sold). Without question, our finest investments over time have been in companies with dramatically rising gross margins. The combination of unit volume growth and pricing power not only drives greater revenues and gross margins, but also a much higher valuation in the market. The chart at the right cuts the Russell 2000 Index into deciles by average trailing 12 month gross margins. The column on the far right states the average firm value (market capitalization + debt – cash) as a ratio to its trailing 12 month revenues. The market correctly rewards higher gross margin companies with a higher enterprise value for every dollar of sales. The task for us as money managers is to identify established growth companies that haven't yet fully hit their gross margin stride, but will likely do so in the years to come.

Ranking	Gross Margin	Firm Value/Sales
<b>1 (worst)</b>	5%	0.8
<b>2</b>	15%	0.7
<b>3</b>	21%	1.0
<b>4</b>	27%	1.1
<b>5</b>	32%	1.1
<b>6</b>	38%	1.4
<b>7</b>	45%	1.9
<b>8</b>	54%	2.3
<b>9</b>	65%	3.0
<b>10 (best)</b>	85%	3.4

*Source: Cortina Asset Management*

*Airlines vs. Software* – A simple example of “wants vs. needs” should illustrate the difference between money losing and money making businesses. During inflationary periods, airlines face multiple costs headwinds (e.g., rising labor, energy, plane construction and development costs). In addition, attempted price pass-throughs by airlines in the form of higher fares and baggage fees drive lower unit demand. Price elastic demand industries are subject to customers effectively setting the tolerable price. These aren’t franchises, but rather horrible businesses that erode value on good days and destroy value on bad days. Software, on the other hand, is a necessary evil that has become an integral computing process those companies and individuals can’t live without. Not only should volumes not collapse during challenging inflationary times, companies should increase their usage to further drive cost saving productivity gains. And since the software companies are effectively the price setters, annual price hikes for license and maintenance services are industry standard. Unlike airline passengers with flight options, software users face material friction costs should they desire to rip and replace their incumbent software system.

At the end of the day, we ask ourselves “Who needs whom more?” and “Who can pass price pressures down the food chain?” Our strategy targets companies with the upper hand, such as software companies. Inflation simply widens the divide between price setters and takers. One uses higher prices to leverage fixed costs for higher profit margins, while the other accepts their position and absorbs the profit margin pressure.

***In Summary:***

- We didn’t sacrifice our philosophy while performing strongly in 2009
- The cyclical beta bounce is over – the transition to higher quality is underway
- The bond market bubble represents fears about more wealth destruction
- Investors don’t fully appreciate the importance of *real* investment returns
- Inflation and interest rates are poised to rise
- Equities historically provide positive real returns during controlled inflation
- Franchise companies are poised to prosper if inflation surprises to the upside
  - Unit growth and pricing power become mandatory
  - Leveraging a fixed cost structure while minimizing variable costs.
  - Utilizing existing capacity is ideal. Rising capex costs are undesirable.
  - Labor and selling costs should be success-based, not rigid.
  - Operational efficiencies are needed to lower working capital costs.
  - Variable debt should be avoided.

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

John C. Potter, CFA  
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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 presentation includes 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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