



Cortina Small Cap Growth Strategy 2nd Quarter 2010 Commentary

The Market's Mood Changes But Ours Does Not (yet)

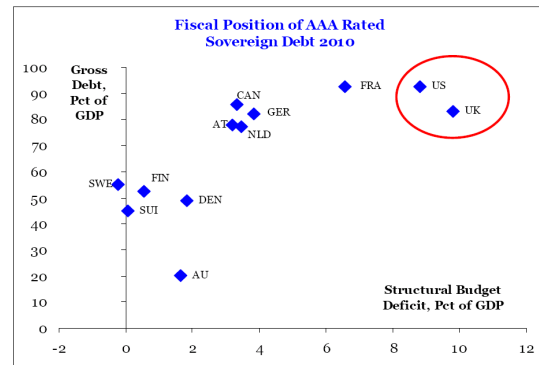
As the second quarter progressed, the market mood became decidedly more cautious. Public chaos in Greece, the “flash crash” and the Gulf of Mexico oil spill dominated the headlines, though we argue that the conclusion of corporate earnings season was the true catalyst for the wall of worry. Coming into the second quarter, few thought there was much, if any, life left in the recession. There were longer-term issues to be sure, but those were worries for another day. Credit markets had been repaired and inventory reductions had been largely completed. Cyclically things were better as evidenced by fourth quarter GDP growth of 5.6%. Even the job market was showing early signs of improvement. To top it off, we were about to be treated to another round of robust growth in reported earnings. For the last three quarters, investors have witnessed an impressive corporate profit rebound as a small amount of demand recovery coalesced with very lean company cost structures. The first quarter in which earnings inflected to the positive took many by surprise. The second dramatically raised confidence. But by the third, robust results were expected and indeed demanded. The conclusion of earnings season brought with it the end of the onslaught of positive news, thus opening the door to a returned focus on the potential dangers that remain. This was exasperated by the sensational headlines referenced above.

The end result was the worst second quarter ever for the Russell 2000 Index. If that statement has a familiar ring to it, it's because there have been a lot of records set in the past three years. Consider the following:

- 2008 was the worst year ever for the Russell 2000.
- Q4 2008 was the Russell 2000's second worst quarter ever.
- Q1 2009 was the worst first quarter ever for the index.
- Q2 and Q3 of 2009 marked two of the ten best Russell 2000 quarters of all time and the third-best two quarter gain.
- The last three years also witnessed the biggest U.S. bankruptcy filing of all time.
- Consumer Confidence Index hit an all time low in early 2009.
- Oil prices hit an all time high in the summer of 2008.
- Gold prices reached an all time high in June of this year.

The list goes on. Phrases and terms such as “The Great Recession,” “Too Big to Fail,” “Green Shoots” and “Austerity” have been permanently embedded into the American lexicon. So too have names like Bernie Madoff, Ramalinga Raju and Allen Stanford.

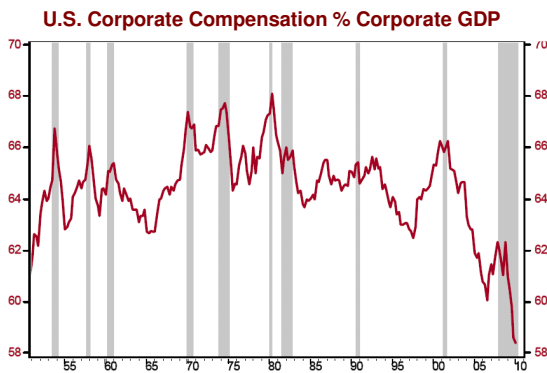
As we write this commentary today, several high level concerns are tearing at long-term investors and apparently restraining flows into equities. The first issue is the state of the Federal balance sheet. Government spending has ballooned—primarily the result of the stimulus package and the bank/auto bailouts. Alongside higher spending, tax receipts have shrunk. The net result is a government living beyond its means and sitting with too much leverage. The accompanying chart from Strategas Research Partners plots America’s situation relative to eleven other AAA-rated government issuers. While this fiscal deterioration has been several years in the making, the red flags went up when the crisis in Greece came to a head. As investors and traders watched the drama from the streets of Athens unfold on May 6, they were reminded that perpetual fiscal deficits cannot be sustained, even by a government. According to the Federal Reserve Board, if plotted on the chart above, Greece would have entered the year with a deficit near 14% of GDP and its debt would exceed 100% of GDP. The U.S. is heading in the wrong direction and something must be done to redirect its path.



Source: Strategas Research Partners

Another trend agitating investors as of late is the strengthening of regulatory winds. The climate in Washington is one of high involvement and activity. Healthcare stocks gyrated for months as healthcare reform evolved and ultimately came to fruition – though many questions remain. Following passage of the massive healthcare bill, reforming the financial industry was next on the agenda. As financial reform progressed, the explosion aboard the Deepwater Horizon drilling rig placed the energy sector on the reform table. Taken together, these three sectors represent upwards of 40% of the stock market making Washington of primary importance to investors. So much so that myriad firms have sprouted in the past 18 months, each with the singular purpose of keeping institutional investors apprised of the latest musings from D.C. The potential for regulatory change fosters uncertainty among business leaders which in turn stifles workforce expansion and capital investment. The intense focus on small changes in policy proposals stifles financial investment.

Progress on the employment front has been underwhelming and holding back consumer spending, consumer confidence, the housing market and politician approval ratings. Hovering around 10%,



Source: Strategas Research Partners

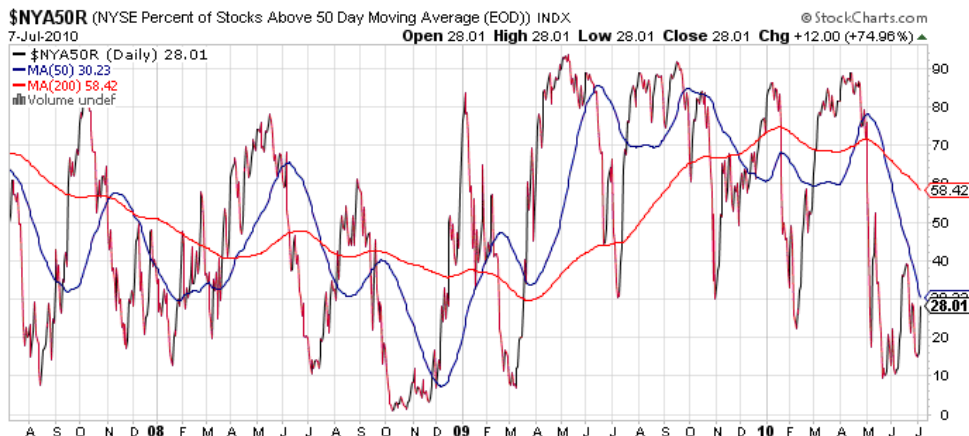
the unemployment rate is having a difficult time retreating. Record levels of productivity reflect hiring that is far from keeping up with the renewed pace of economic activity. This level of efficiency is having a magnificent impact on corporate profitability. The accompanying chart from Strategas Research Partners displays the uncharted territory we are in regarding the relationship between corporate compensation and GDP. We subscribe to the theory that, ultimately, this level of efficiency is unsustainable and could portend better prospects ahead for the American worker.

The backdrop painted by the issues described above has contributed to the passing of the baton from greed back to fear. Many of the customary measures of investors' attitude toward risk reflect this: credit spreads are elevated, volatility is up, money is abandoning equities, treasury yields have fallen and the AAI reports that only 25% of surveyed investors are bullish. From the April 26 high to the end of the quarter, the S&P 500 Index is down 15% and the Russell 2000 Index has fallen over 18%. The primary fear we suspect is that the double-dip recession is increasingly more probable. Coincident indicators are also suggesting a double-dip is on the horizon:

- Copper prices are down 17% in the quarter while gold prices are up 12%.
- Crude oil prices have fallen by 10%...the first quarterly drop since 2008.
- The Baltic Dry Freight Index has collapsed.
- The Chinese stock market (as measured by Shanghai A shares) is down 23%.
- Utilities and Consumer Staples (perceived safe havens) led the market in Q2 while Energy and Consumer Discretionary (highly cyclical) sectors performed the worst.
- Consumer confidence is fading.

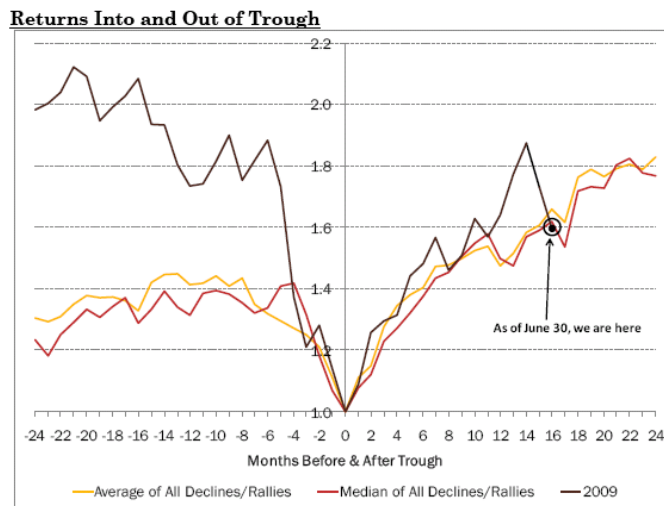
From the bottom up, however, there is little evidence supporting the allegation. From much of corporate America's vantage point, the recovery remains at hand. At least that is the prevailing sentiment from the majority of the company leaders with whom we have been talking. As a firm, we met with 224 distinct company management teams in May and June, and for most, demand trends are not changing. To the contrary, most suggest the recovery remains at hand. We would subscribe more value to the double-dip noise if we had tangible data points and anecdotes from the front-line to verify the changing economic mood. What *is* factual is that the rate of growth is starting to slow. This is to be expected as we have cycled through the months that are measured against the deepest part of the credit freeze one year ago.

Stocks today may be oversold. In last quarter's commentary, we tried to frame where we are in the recovery relative to where we had been. Signs of structural repair were everywhere. We mentioned in the commentary that we had suspicions of equities being overbought in the short term, and we referenced the high levels of stocks then trading in excess of their 50-day moving averages. After the market correction referenced above, the ratio has been turned exactly on its head as seen in the chart below from StockCharts.com. Breadth of this magnitude is often a harbinger of a short-term trend reversal...said differently, the emergence of incremental sellers may be dwindling.



Source: StockCharts.com

The small cap technical specialists at Furey Research Partners published the chart below, which gives us some perspective on the recent sell off. It looks at the return of small cap stocks* in the months surrounding the March 2009 market trough (“0” on the horizontal axis) and compares it to the average magnitude of declines and rallies experienced around eight prior bear markets. This overlay suggests that when examining the entire small cap equity journey thus far, it is not meaningfully out of synch with what could be considered “normal.” Interestingly this chart was found in a research piece titled “Correction or Inflection?” A clever title framing today’s debate as we see it. Until we hear otherwise from the private sector, we suspect the answer is the former rather than the latter.



Source: Furey Research Partners

**Prior to 1979, data set used Ibbotson CRSP Deciles 6-8. Post 1979, the Russell 2000 Index is used.*

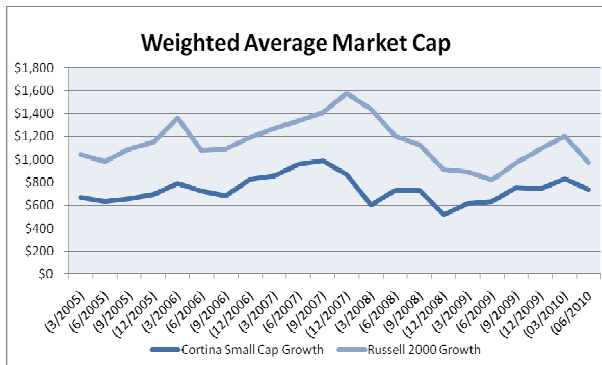
We contend equities are under-owned and out of favor and valuations remain attractive. Over the years, however, we have learned to remain very sensitive to what the market is saying because it is often quite prescient. Our antennae are up and we are actively searching for evidence of weakness on the margin. Where we anticipate it, we have been selling the corresponding stocks. Earnings reporting season should provide us a good opportunity to listen for directional changes in the recovery. We expect that if the message from companies remains largely unchanged, interest in stocks should return. One clear risk to published estimates is the negative impact of currency moves. Some of our holdings have exposure but by their nature, small caps should be less exposed than large caps.

While most forecasts show the U.S. economy still growing around 2.5% in 2011 and the Chinese economy—the world’s growth engine—expanding by 10%, a consensus view is far from clear. There are a seemingly equal number of voices calling for a double-dip recession as there are for continued economic expansion. We hear passionate arguments that we are on the brink of crippling inflation and deflation (see recent trends in gold prices versus copper prices). Attempting to pick a side of the various arguments and position portfolios accordingly seems a dangerous endeavor. Instead, we are primarily investing in two types of companies: secular growth stories often contained within our fourteen themes, and companies that are benefiting from reduced competition or pent-up demand following the events of 2008 and 2009. These companies should have better prospects for growth in a range of economic outcomes.

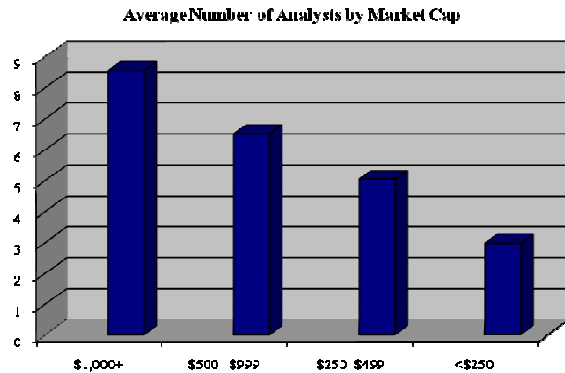
Cortina Turns Six Years Old

For the past three years, and since the firm’s inception six years ago, we have focused on providing our clients with a consistent process designed to deliver results in a variety of market environments. Our goal at the outset was to generate annualized alpha of 250 basis points and that remains our goal today. Six years into our product’s history, we have come up just short of our goal having generated annualized alpha of 239 basis points. The full data set is still not available, but preliminary data suggests this will place us around the top quartile of small cap growth managers over that time period. The three and five year performance numbers tell a similar story – slightly less than our stated goal of 250 basis points of alpha but ahead of most competitors. We would like to highlight a few of the strategy’s hallmarks that have contributed to the product’s success over the years.

One aspect of our strategy that we believe is unique is our comfort with the smaller end of the small cap spectrum. Our weighted average market cap has consistently been below that of our benchmark index, the Russell 2000 Growth, as the nearby chart displays. We like investing in these companies not because they provide higher returns over time (though the data suggests micro caps do offer superior returns over time), but rather because we feel that smaller companies offer us, as analysts



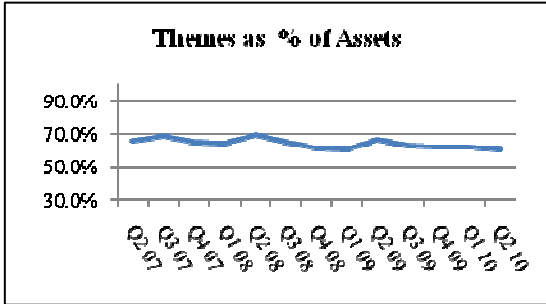
Source: FactSet Research; Internal Documents



Source: Thompson Financial

and portfolio managers, the opportunity to gain an advantage through our research process. The data bears this out as well. As the accompanying chart shows, on average, less than three analysts publish research on companies under \$250 million in market cap. By comparison, companies with a market cap in excess of \$1 billion are followed by more than eight analysts on average. We believe less coverage results in greater inefficiencies, providing a greater opportunity to generate alpha without taking on undo risk. Many managers buy micro caps tactically as part of a beta or low quality trade. We strategically invest in high quality small and micro cap companies that are underfollowed, undiscovered or misunderstood.

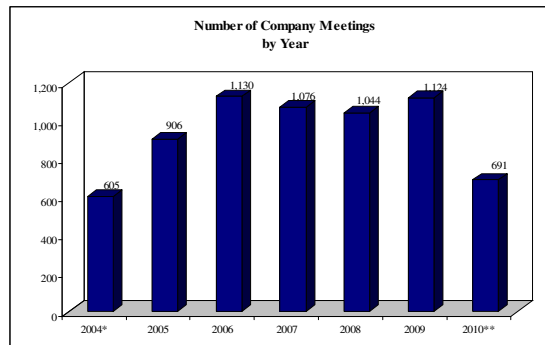
One of the most important aspects of our process is thematic investing. Those familiar with our strategy know that when we talk about thematic investing, we are talking about a process that is much more calculated and creative than a simple basket approach. A good theme consists of several investments across industries and sectors that all benefit, either directly or indirectly, from a common tailwind. In the past three years, we have created thirteen new themes and retired fifteen themes. While not every theme has been profitable, our thematic process has been instrumental in



Source: Cortina Asset Management

keeping us invested in secular growth trends during a cyclically difficult and uncertain period. Themes have consistently represented between 60% and 70% of portfolio assets – this is not a precise target to which we manage, but rather a function of our process. We are constantly on the lookout for new themes to invest in and welcome any ideas.

The lifeblood of our product and our firm is fundamental research. Since starting Cortina in 2006, we have spent over \$500,000 pursuing information around the globe. Analysts and portfolio managers have been to China five times. We have had face-to-face meetings with more than 2,000 small cap companies. In 2009 alone, we attended 88 investment conferences, conducted primary research in 24 states and made more than a dozen trips to Washington, D.C. – an increasingly important piece of the investment mosaic. This occurred in a year in which many investment firms faced budget cuts and travel restraints. Company meetings are crucial to our strategy of investing in lesser followed small and microcap companies. As discussed above, we also find the perspective we gain from these interviews to be more valuable in building our macroeconomic views than relying on backward looking statistics.



Source: Cortina Asset Management

We are devout believers in our process and are proud of the longer-term results it has generated. We will continue to trust in it to help us navigate through the uncertainties that abound in the market today.

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.
3. Additional information about Cortina is contained in the firm's Form ADV. Cortina will supply a copy of its Form ADV to any prospective client upon request