

Global Perspective
GCM Small to Mid Cap Core – Portfolio Update
July 16, 2009

Depression Dodged

While quarter two of 2009 most likely marked the 18th month of continuous economic contraction, equities rallied smartly on both a snap-back from extreme low valuations and the likelihood that the rate of economic decline is slowing. Between the thawing of credit markets and worldwide economic stimulus plans, I think we can safely estimate that the current US recession – the second longest since the Great Depression – will not lengthen or deepen to levels seen in the 1930s. Globally coordinated Monetary and Fiscal policy stimulus is greater than that ever seen or imagined before. Moreover, the US \$787 billion economic stimulus plan appears to be just the first part in the Obama administration's agenda, as talks of more stimulus are in the works. Fiscal policy has been equally supported by both standard monetary easing measures, like the lowering of the Fed-Funds rate to near zero, and by a creative Alphabet Soup of lending, Quantitative Easing, capital infusion, bailout, loan guarantee and forbearance programs of immense proportions. The \$700 billion Troubled Asset Recovery Program (TARP), created in October 2008, has now been used as a bank capital infusion program and a mechanism for the bailout of AIG and the auto companies. In November, the Fed created its now \$1 trillion TALF program, in an effort to increase credit availability and support economic activity by facilitating renewed issuance of consumer and small business ABS at more normal interest rate spreads. Finally, on March 23rd, the US Treasury announced the Public-Private Investment Program (PPIP) to buy toxic assets from banks' balance sheets. Although the unemployment rate spiked to a 26 year high of 9.7% in June, we expect this abundance of monetary and fiscal actions to spur mild economic growth in 2010.

Kass' Generational Low

In a mid-first quarter analysis, we produced a chart showing the historical Price to Value measure of the S&P Small Cap Index over the last 10 years with the following caption "Small Cap stocks are currently two standard deviations away from the historical median Price to Value (PVA). Based on PVA, if interest rates remain at the same level a 42% return for Small Cap Stocks brings them to one standard deviation below the median. While valuation is not a good timing tool, at these extreme levels of valuation we feel that further downside risk is low." From March 9th thru 2nd quarter end, the S&P Small Cap Index appreciated 47%, thus placing Small Caps at just cheap levels relative to current interest rates and expected growth rates. A very timely hedge fund investor, Doug Kass, forecasted in early March that low interest rates, deeply bearish investor sentiment, and compelling valuations conspired such that US equities had reached a "Generational Low". While small caps stocks are now no longer at their extreme two standard deviation levels of undervaluation, we believe high quality companies still offer a tremendous value.

Performance Review

Second quarter equity market performance was highlighted by the out-performance of the more speculative sectors and indices as investors quickly responded the what we call "a second derivative rally" concluding that economic and earnings declines will now occur at a slower pace. For the 1st half, our Smid Cap Composite out-performed the Russell 2000 by over 1% as our exceptional down market performance in Q1 was partially mitigated by our inability to keep pace with the speculative nature of the Q2 advance. Year-to-date, our conservative fully-invested, Smid cap strategy has out-performed the Russell 2000 on 86% of its down days. We believe our unwavering focus on high quality, undervalued companies with improving business prospects will continue to benefit clients as investor's appetite for risk becomes more even-keeled. We expect the anticipated sub-par economic advance will

temper animal spirits and investors will re-focus on companies with sustainable and consistent growth models.

Construction

Over the last few quarters, we have spent considerable effort transitioning the portfolio towards a more sector-neutral stance – quickly re-positioning in 2008 from highly cyclical sectors like energy, materials, autos and industrials towards less cyclical sectors such as finance and consumer staples. In the same regard, we have viewed the economic slowdown with near certainty and as such have re-doubled our focus on high quality companies – avoiding those with high financial or operating leverage. When we discuss quality, we use it in the same vein as durability. We remain focused on companies which have the balance statements and business models to both withstand the extended current downturn in the economy and prosper in the subsequent recovery.

Despite the Smid Cap portfolio's slight under-exposure to cyclicals (20.7% vs 23.7% Russell 2000), we believe that the portfolio will be properly sensitive to both a continued advance and potential counter-move in stock prices.

Characteristics

Portfolio Characteristics**	June 30, 2009		December 31, 2008	
	GCM	S&P SMID	GCM	S&P SMID
Price to Earnings	11.3	19.3	9.1	13.2
Price to Value	0.57	0.58	0.38	0.44
Debt to Equity	0.45	0.65	0.28	0.65
Earnings Variability	25%	73%	15%	60%
Projected Growth Rate	14.0%	12.5%	14.0%	12.0%
Historical 5yr EPS Growth	23.8%	13.4%	25.0%	16.1%