Global Perspective
GCM Small to Mid Cap Core – Portfolio Update
January 12, 2010

Labor's Bottom

It's been so long since the US labor market has felt any confidence. In 2009, unemployment topped 10%, the labor force shrank by a post-war period record 0.6%, job losses since December 2007 reached 7.5 million workers, and the labor force participation rate was the lowest since 1985. Just as stock prices and other Leading Economic Indicators are useful forecasters of economic activity, growing temporary workers, fewer claims for unemployment, and gains in GDP all anticipate a positive change in the employment landscape. Moreover, total online help wanted ads in December rose 7.5% year-over-year, showing the largest monthly gain since November 2005. Despite calls for a "jobless recovery", we believe that the economy is on the cusp of sustainable job creation just 9 months after the longest and deepest recession in the post-war period.

Sustainability

While the Great Recession of 2008-2009 is now seven months behind us, the current weakness in the labor market, as previously highlighted, begs the question – Is the current recovery sustainable? Not only do we think that economic growth is sustainable, we think it's accelerating. Fiscal policy stimulus in the form of Cash-For-Clunkers and a Housing Tax Credit conspired with already low car and home inventories to help the economy accelerate in the 4th quarter from the 3rd quarter's 2.2%. Moreover, first half 2010 growth will be supported by still low manufacturing inventories, paltry new home inventories, and attractive borrowing rates. Combined with the persistent optimism implied by the ISM Manufacturing Index and a revival in world trade, these factors foretell higher investment spending and hearty inventory rebuild. Ironically, the greatest risk to 2011 economic growth may be overheating and its impact on interest rates, inflation, and global Monetary Policy.

Earnings Momentum

Although the first glimpse of 4th quarter earnings was mired by a disappointing report from Alcoa, the final results should show that earnings momentum is sharply positive and has benefited from a multitude of factors: headcount cost cutting, lower financing costs, fewer write-offs, and now improving revenue. Fourth-quarter 2009 earnings are expected to be up in excess of 80% from the year-earlier period. This impressive growth is not solely due to the ugliness of the fourth-quarter 2008 results, but rather a function of the structural improvements noted. With profits rising, corporate balance sheets improving, and confidence gaining, we anticipate that increases in capital spending and hiring will support a sustained earnings advance for many industries. To this end, we shift our focus to expected earnings growth in 2011 which should exceed 20% on top of a vigorous 2010 gain. While this seems like extraordinary expectations, it is typical for earnings growth to rise rapidly in the early years post-recession as companies benefit from the slingshot effects of lower costs, inventory replenishment, and pent-up demand.

Shifting Policies

As global economic growth benefited from a synchronized stimulative fiscal and monetary policy response to the recession, the unwinding of such policies is beginning. To combat

anticipated GDP growth in excess of 15%, China has signaled an accelerated tightening of monetary policy by raising bank reserve deposits. In addition, India, Brazil and Canada are also reconsidering methods of reducing liquidity from their systems. On the fiscal policy front, the US, England, France, and Italy should begin considering austerity measures as their high debt levels are increasingly becoming a concern to the credit markets. While these changes are in their early stages, it's important to note that some of the ultra-stimulative policies of the past will no longer provide a positive economic jolt into future. Despite initial signs of labor market improvement, absorption of capacity and mild inflation, we do not expect the Fed to alter its near-zero interest rate policy until bank lending standards materially ease for both businesses and consumers.

Junk Crushes Quality

Fully six months into the economic recovery, US equity prices continued their advance through the fourth quarter. Now nearly eleven months old, this bull market bounce back of 59% mirrors the average of the last 10 post-bear market rebounds. The out-performance of cyclical and higher risk stocks has had only a short break since began on March 9th, 2009. For the year, the Barclays Capital High Yield (low quality) Bond Index soared 58% while "safe" long-term Treasuries crumbled 13%. The MSCI Emerging Markets Index gained 62.3% while the DJIA gained "only" 18.8%. GCM Equity portfolios gained more than 20% in 2009 but did not keep pace with the higher risk indices. Equities have been supported by unprecedented monetary and fiscal policy stimulus both of which have lifted the US economy from the longest and deepest post-war recession. By eliminating the depression scenario, higher risk companies – like junk bonds – that were priced for potential extinction, have been the greatest beneficiaries.

Quality Matters

Even as economic uncertainty has been lifted and the appetite for risk restored, we still argue that investing in undervalued, high quality companies with improving business prospects provides the highest probability of investing success. Both long-term historical performance and the current investing environment support this philosophy. First, high quality companies are extraordinarily cheap when compared to all other equities. Compare to all other companies, high quality companies remain two standard deviations cheap relative to their historic average. (Please review our attachment which compares the price-to-value ratio of high quality companies to all other companies since 1974.) Second, high quality companies – those companies which have a durable competitive advantage – have historically demonstrated 1/3 less volatility (standard deviation of returns) than other stocks. Finally, as the uncertainty of depression has been removed, low quality companies have already received out-sized benefit from the adjustment in expected cash flows. This removal of the depression scenario can not be repeated. Thus, as expectations for future growth temper – because of either high consumer debt levels, high federal debt levels, or increases in tax rates to finance our exploding deficits – the reintroduction of slow or negative economic growth will pose undue harm to those companies with less certain (less durable) cash flows.

Construction

As earning estimates have shifted to cyclical and technology companies, we have slightly adjusted the portfolio to reflect these changes. As of December 31, 2009, our weighting in Energy, Materials, Industrials and Technology was 45.0% vs. 41.8% for the Russell 2000.

Our process of searching for high quality, undervalued companies with improving business prospects remains unwavering. When we discuss quality, we use it in the same vein as durability. We remain focused on companies that have the balance sheets and business models that withstood the current economic downturn and will prosper in the subsequent

recovery. Our focus on quality will continue to help the portfolio during periodic down periods. During 2009, our SMID Cap Strategy outperformed the Russell 2000 on 82% of its down days.

Note: The recent out-performance of more cyclical and risky sectors since the March 9th low is consistent with the 2003 period as investors scrambled to get beta exposure. As investors became more selective in 2004, our unwavering focus on quality was rewarded. Although, we expect the market to be generally higher by year end 2010, we recognize that advance likely will be more tempered than the thrust since March 9th. As such, we do not want to completely shift the portfolio to the highest risk components of the market, yet we acknowledge that cyclicals will likely have the most earnings leverage in 2010 and 2011 and as such have adjusted the portfolio in response.

Top/Bottom Smid Cap Performers for 4Q09 thru December 31, 2009:

Top Contributors by Holding			
Company Name	Avg Wt	Return	Contrib
ALLEGIANT TRAVEL CO	1.92	23.84	0.54
FOSSIL INC	3.03	17.96	0.52
CSG SYS INTL INC	2.73	19.24	0.50
PROSPERITY BANCSHARES	2.89	16.79	0.44
WORLD ACCEP CORP	0.67	22.16	0.40

Bottom Contributors by Holding			
Company Name	Avg Wt	Return	Contrib
TRUE RELIGION	2.41	-28.69	-0.86
AEROPOSTALE	2.83	-21.67	-0.72
KNIGHT CAPITAL	1.69	-29.20	-0.71
SYNTEL INC	2.35	-20.20	-0.66
SIGMA DESIGNS INC	0.59	-17.34	-0.34

The Financial Services sector was the largest contributor to the performance of the portfolio - helped by performance of Prosperity Bancshares (PRSP) and World Acceptance Corp (WRLD) and hurt by Knight Capital (NITE). PRSP has been able to maintain profitability and credit quality through the economic downturn. WRLD reported record results last quarter and earnings estimates have continued to increase. NITE missed earnings last quarter after beating the previous three quarters. We reduced our position in the stock to 1.5%. Health Care and Producer Durables were also top sector contributors. Note: We continue to have excellent downside protection this year outperforming the market on 82% of its down days.

Characteristics

	December 31, 2009		December 31, 2008	
Portfolio Characteristics**	GCM	S&P SMID	GCM	S&P SMID
Price to Earnings	14.0	26.1	9.1	13.2
Price to Value	0.65	0.71	0.38	0.44
Debt to Equity	0.41	0.65	0.28	0.65
Earnings Variability	22%	90%	15%	60%
Projected Growth Rate	13.0%	12.0%	14.0%	12.0%
Historical 5yr EPS Growth	16.7%	-0.4%	25.0%	16.1%

Worst U.S. Market Declines And Their Explosive Rebounds*

		Within 1 Year	Within 3 Years	Within 5 Years
Sept. 1929-July 1932	-89.5%	+172.2%	+212.8%	+381.8%
Mar. 1937-Mar. 1938	-50.2%	+63.0%	+42.4%	+40.7%
Jan. 1973-Dec. 1974	-46.6%	+56.0%	+80.0%	+59.3%
Sept. 1939-Apr. 1942	-41.3%	+48.3%	+78.8%	+130.2%
Aug. 1987-Oct. 1987	-41.2%	+35.8%	+87.1%	+112.5%
Jan. 2000-Oct. 2002	-38.8%	+36.9%	+52.6%	+97.3%
Dec. 1968-May 1970	-36.9%	+52.7%	+70.1%	+38.4%
Nov. 1961-June 1962	-29.2%	+39.7%	+80.1%	+90.8%
Sept. 1976-Feb. 1978	-27.7%	+22.3%	+36.5%	+53.0%
Feb. 1966-Oct. 1966	-26.5%	+29.4%	+35.2%	+30.2%
Current bear market Oct. 2007-Mar. 2009	-54.4%			
AVERAGE REBOUNDS		+55.6%	+77.6%	+103.4%

*Based on Dow Jones Industrial Average.
Index is property of Dow Jones & Company.