



Global Perspective GCM Small Cap Core – Portfolio Update

May 31, 2011

Quality Stabilizes in First Quarter

Stock prices built upon their two-year advance in the first quarter of 2011, as both large-, mid- and small-cap indices gained more than 5%. Since the March 9, 2009, trough, the S&P 500 has nearly doubled, while small caps have advanced 146%. While returns were muted, high-quality stocks performed in-line with the average stock, due to the two-fold effect of the nascent economic recovery and a bull market. During the “middle innings” of the market’s advance, investors are often less willing to recklessly put “Risk On!” While we believe that a continued economic expansion will push earnings and stocks higher, we recognize that the average stock is now fairly valued. However, we believe that high-quality stocks remain an extraordinary value on both a nominal and relative basis.

Our GCM Small Cap strategy posted performance roughly equal to its benchmark during the first quarter of 2011, outperforming the Russell 2000 by 0.25%. During the first half of the second quarter, relative outperformance has slightly expanded. Contributions to performance gains were made across varied sectors: Medicaid Insurer (Amerigroup), Financial Services (World Acceptance), and Industrials (Atlas Air Worldwide), aided this strategy.

Transitory or Permanent?

Both U.S. economic growth and inflation disappointed during the first quarter. GDP downshifted to 1.8% from 3.1% in the fourth quarter of 2010, demonstrating the slowest growth since Spring 2010, when European debt crisis fears unfolded. Additionally, core producer price inflation (PPI) reached 3.1% in February - more than 3% higher than the relatively benign inflation of October 2009. While Federal Reserve Chairman Bernanke recently argued that the current spike in inflation is transitory, higher inflation in emerging economies, a falling dollar, and rising energy prices would suggest otherwise. Despite efforts to cool economic growth, Chinese inflation remains stubbornly high at 4.9%, despite the yuan reaching an 18-year high against the dollar. Notably, as of this writing, oil prices now hover near 30-month highs, thus supporting higher commodity prices more broadly. As economic growth continues to surge in China, Brazil, and India, we expect that the first quarter’s slow economic growth was merely a “speed bump,” while inflation’s uptick is likely permanent.

While the first round of quantitative easing (QE1) – or overt reserve stimulus – successfully aided the economy and stabilized financial markets from the crisis of 2008, it did not increase lending. The follow-on easing (QE2) has been coincident with both stabilized lending and increased inflation expectations. To this end, the slope of the yield curve – or the spread between the yields of two-year and 30-year Treasury securities – has risen to 4.01%, the highest level since 1977. In both QE1 and QE2, Fed policy appears to have accomplished its desired objectives. Going forward, Fed policy will likely consider the reduced chance of a double dip recession, falling levels of unemployment, rising commodity price inflation, and a

pick-up in commercial lending. Although central bank tightening seems far off, Fed policy must now begin to balance sustaining growth, while considering the current signs of economic acceleration as a potential threat to long-term inflation. The current zero interest rate policy is working for now – but presents long-term risks, as slack is removed from the labor, input, and commodity markets.

Taylor's Rule

Usually, I generally agree with our Fed Chairman. Typically, his economic and inflation insights are “spot on,” but I think in the case of inflation highlighted above, Bernanke is temporarily “talking his position.” Confronted with a logical dilemma, he can't simultaneously maintain a near-zero interest rate policy, and acknowledge a permanent rise in the level of inflation. Guided by a Taylor's Rule type of monetary policy, the Chairman has dual mandates: maximum employment and contained inflation. As employment remained below full-employment, while inflation was subdued, it was easier for our central bank to choose accommodative monetary policy to stimulate lending and economic growth. As policy remains what many believe to be ultra-stimulative, while inflation begins to advance, the Fed will either have to abandon its inflation mandate, or adjust both its policy and language. Halting QE (in any form) in June is probably just the first of many steps in a changed U.S. monetary policy.

Portfolio Construction

Overall sector weights for the Global Capital Management Small-Cap strategy were largely unchanged during the quarter. Our positions in the Financial and Industrial sectors remain highest, reflecting their respective index weightings. At quarter-end, our weighting in cyclicals – Energy, Materials, Industrials and Technology – was between 43% and 47%, mirroring the cyclical weight of the Russell 2000. As cyclical stocks have dramatically outperformed the other sectors of the market, our ability to find attractively priced stocks in these areas is becoming more difficult. As we have seen in prior cycles of economic expansion, business momentum would naturally push us towards a dramatic cyclical overweighting at this point in the economic cycle. Mindful of the risk of this tendency, our cyclical sector weighting in both our Small-Cap strategy is within one stock position of each strategies' respective benchmark.

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 last economic downturn, and that we believe are positioned to prosper in a subsequent recovery. Our focus on quality will continue to help the portfolio weather the storm better during down periods.

High Quality Equities Remain Best Option

While all classes of U.S. equities have made significant gains over the last two years, we believe that the nominal and relative attractiveness of high quality U.S. equities is extraordinary. High-quality equities are supported by 1) compelling relative valuations, 2) strong and improving corporate balance sheets, and 3) stable global economic growth/inflation. Using our price-to-value metric, high-quality small-cap, mid-cap, and large-cap companies are all cheap relative to interest rates, anticipated earnings growth rates, and lower-quality equity alternatives.

Small Cap Characteristics

Portfolio Characteristics	March 31, 2011		December 31, 2010	
	GCM	S&P Small	GCM	S&P Small
Price to Earnings	15.5	23.9	15.4	24.2
Price to Value	0.79	0.86	0.70	0.79
Debt to Equity	0.46	0.45	0.53	0.45
Earnings Variability	36%	96%	37%	103%
Projected Growth Rate	13.0%	12.0%	13.0%	12.0%

Top/Bottom All Cap Performers for 1Q11 through March 31, 2011:

Top Contributors by Holding			
Company Name	Avg Wt	Return	Contrib
Amerigroup, Corp.	3.11	46.29	1.26
World Acceptance Corp.	3.22	23.48	0.70
NewMarket Corp.	2.00	28.68	0.55
Medicis Pharmaceutical	2.58	19.89	0.49
Ezcorp Inc.	2.82	15.70	0.44

Bottom Contributors by Holding			
Company Name	Avg Wt	Return	Contrib
USANA Health Sciences	0.91	-20.58	-0.61
Hibbett Sports, Inc.	0.70	-2.95	-0.31
Black Box, Corp.	1.03	-8.04	-0.23
Microsemi, Corp.	2.43	-9.56	-0.23
Cato Corp.	0.76	-9.94	-0.23