April, 2006

IronBridge Capital Management, L.P.
First Quarter 2006 Small Cap Core Review

Dear Fellow Investor,

The IronBridge Capital Small Cap Core product was up approximately 11% for the first quarter of 2006, making it a great start to the year on an absolute basis. While the high-flying Russell 2000 Index soared even further, ending the quarter at an all-time high and increasing 13.94%, the period proved more challenging on a relative return basis. Throughout the quarter, we were surprised by the strength of small caps and especially by how much they trounced all other investment categories for the quarter.

Investment Performance
Q1 2006

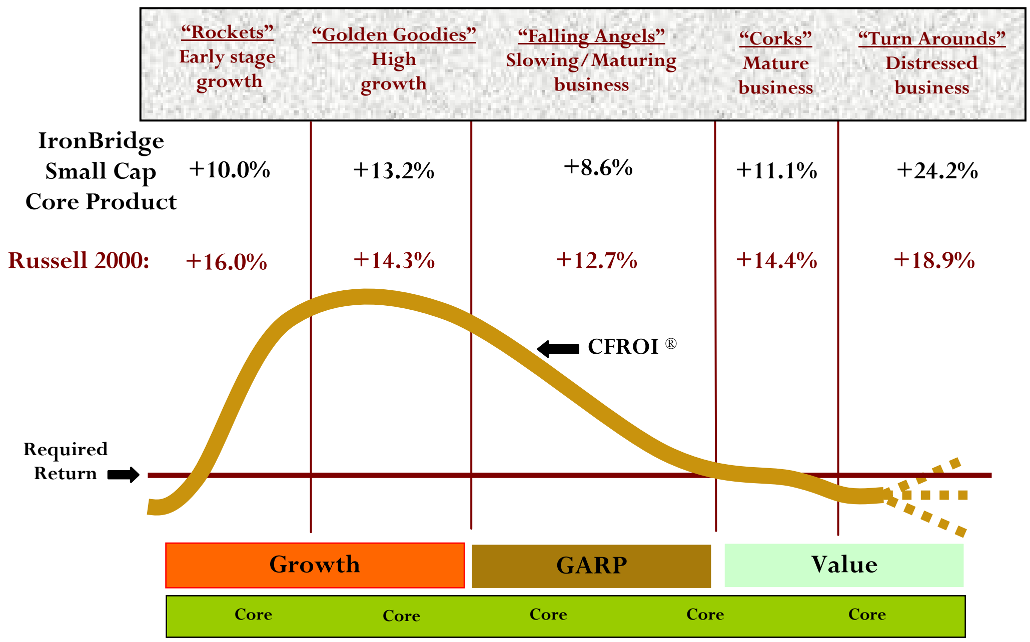
Category	Index	Performance
Small Companies	Russell 2000	+13.9%
Midcap Companies	S&P Midcap 400	+ 7.6%
Large Companies	S&P 500	+ 4.2%
All Cap Market	Russell 3000	+ 5.3%
International Co's	MSCI EAFE	+ 9.5%
Gov't Bonds	Lehman Bond Index	- 0.7%
Muni Bonds	Lehman Muni Index	- 0.3%

Source: Lehman Equity Research

The Russell 2000 Index left every other investment class in the dust and was almost impossible to keep up with because its advance was led by illiquid, speculative, low-quality stocks. For the record, we can't buy the least liquid or lowest quality stocks in the Russell 2000 Index because our process screens them out. However, we do own companies that are doing the right thing to create shareholder value with a high probability of beating expectations over the long term. Those stocks in our portfolio did very well, but they were up "only" 11% for the quarter. We are never pleased about trailing the indices, but we were not the only ones who could not keep up. According to Lehman Bros. Equity Research, 75% of small cap managers trailed the Russell 2000 Index, so we are all in the same boat regarding liquidity and quality restraints. According to the WSJ Mutual-Fund Yardsticks

Quarterly Review, the average Small-Cap Core fund was up 12%, which puts us right in the hunt. If experience is any guide, we suspect those illiquid, low-quality, speculative names will have a difficult time holding on to gains as investors eventually will price economic reality.

First Quarter 2006 Returns by Life Cycle



First Quarter Attribution:

Generally, our portfolio was more cautiously positioned than usual, underweight in Rockets and Turn Arounds and overweight in Corks and Golden Goodies. In addition, the portfolio contained slightly higher than normal cash levels during the period.

Stock selection contributed approximately 180 basis points of the underperformance for the quarter, but we believe that our stock selection is better than it appears on paper. While it wasn't that we had problems with stocks that we own, it was simply that our stocks could not keep up with the less liquid, lower-quality stocks that were driving the Russell 2000 Index.

As mentioned, another contributing factor this quarter was cash drag, which detracted nearly 80 bps. We ended the quarter with a cash level of nearly 5%. Cash was higher than we would have liked during the quarter because we identified more selling opportunities than buying opportunities. Some selling opportunities were too opportunistic to pass up. For example, OSI Systems is a company that was selling near our price target, and we were beginning to have doubts about the quality of the management. Conveniently, Jim Cramer (the pump and dump king on CNBC's "Mad Money") touted OSI to his fans as a "Booyah!

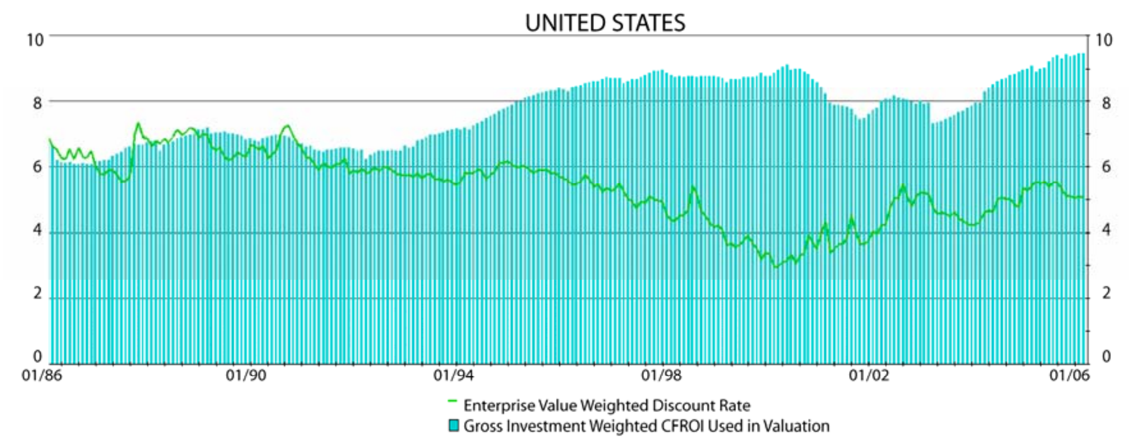
Buy! Buy! Buy!" In response, the stock gapped up to $23 on 1.6 million shares, 10 times the stock's normal volume. Given the opportunity to quickly sell a larger number of shares, we could not resist. We had to sell it to the hot, speculative crowd. Today it trades at $19, down 17% from our selling price. Thanks, Cramer, for facilitating our transaction.

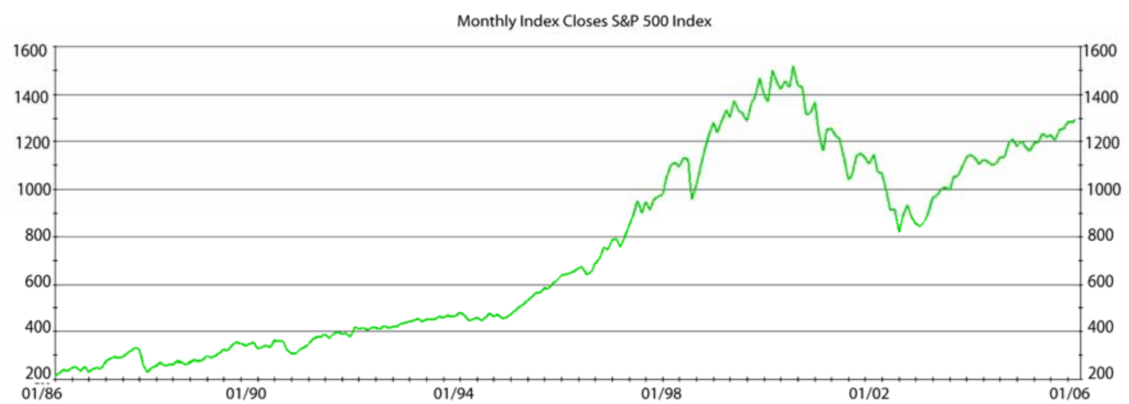
Sector allocations contributed marginally to the relative return profile during the quarter. The portfolio's underweight in Financial and Consumer stocks and the overweight in Industrials and Materials helped performance. The underweight in Technology and overweight in Utilities detracted. By sector, our stock selection was solid in the Healthcare group. Our Healthcare holdings were up 14%, compared to 11% for the Russell Healthcare group. Stock selection was pretty good for Industrials and Financials, which approximately matched the Russell 2000 groups. Stock selection, while good, simply could not keep pace in the Materials, Energy and Consumer Discretionary groups. Our Materials holdings were up 18.6% compared to 28.2% for the Russell 2000 Materials group. The exceptional advance for the Materials component of the Russell 2000 Index was driven by a spike in gold, which is at a new high; silver, which was up 30% for the quarter; copper, which was up 20% for the quarter; and steel companies, which were up on stronger steel prices as well as merger and acquisition activity/speculation. We owned several well-managed Steel companies like Chaparral +150% and CMC + 39%, but we did not own any pure play gold, silver or copper companies, which trade by appointment, and whose performance is entirely dependent on the price of the underlying commodity. We do not own gold, silver and copper stocks because we have no competitive advantage regarding forecasting commodity prices.

The portfolio's Energy holdings were up 5% versus 12% for the Russell 2000 Energy sector because we have a tilt in our Energy holdings towards natural gas. Natural gas prices were down 35% this quarter due to an unusually warm winter. We believe this is cyclical and should reverse eventually, resulting in better performance from our energy holdings. The underweight in Consumer Discretionary added value, but our stock selection was poor. One of our larger holdings, Wolverine World Wide (WWW), was hit by extenuating circumstances. WWW has a highly-skilled management focused on shareholder value creation, but they were hurt because the European Union decided to slap protectionist tariffs on all leather goods imported from China, which affects a good portion of WWW's sales. The market reacted by punishing their shares. Finally, our Technology holdings were up 13% compared to 17.5% for the Russell 2000 Technology shares. Leading the Technology surge were the Turn Arounds. We are reluctant to buy Tech Turn Arounds because often tech companies suffer from obsolescence, which is harder to fix than other businesses that just need to right-size their business. For example, it is easier to fix a shoe store, like our successful investment in Payless Shoe, than it is to replace an obsolete product. Our higher–quality, Tech holdings significantly lagged the performance of the lower-quality Tech Turn Arounds. Again, we believe this to be unsustainable.

Current Investment Environment:

Corporate profitability is at an all-time high. The investor's discount rate for small companies is at an all-time low. Economic and profit growth is robust. Ninety percent of our stocks met or exceeded our expectations for sales and cash flow growth. Only 10% disappointed, and those that did only modestly disappointed. The chart below shows CFROI for corporate America for the last 20 years. It has NEVER been higher. The environment for wealth creation has never been better.





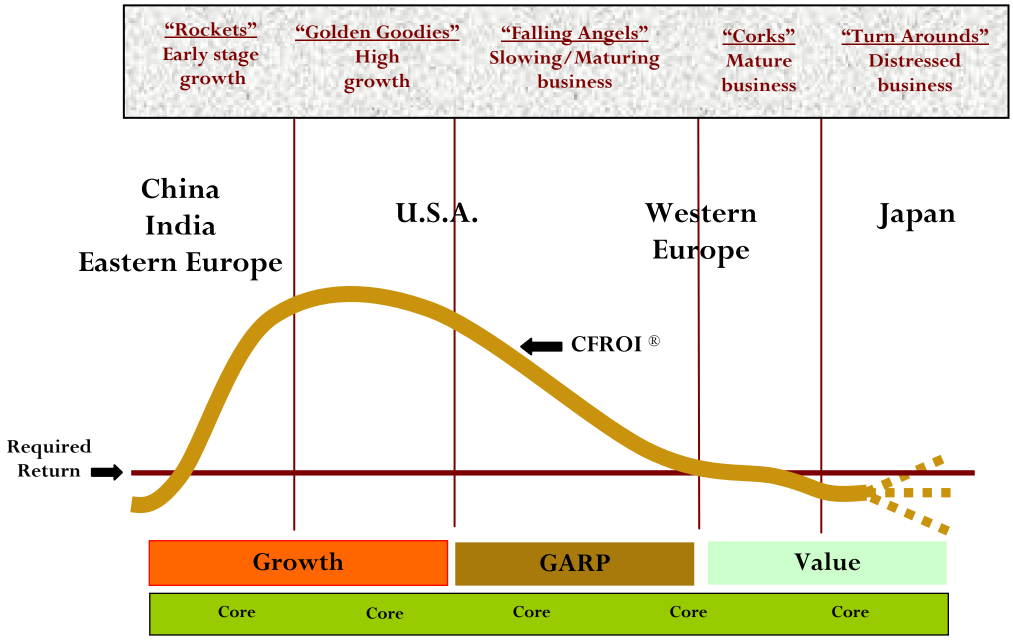
Source: CSFB HOLT ValueSearch™

Recall in our last quarterly commentary we had identified several anomalies that made us ask "Is it different this time?" The answer is yes. It is always different because the world is evolving. However, what does not change are the market forces which we believe are best understood through our Life Cycle framework. To understand how the world is evolving it is helpful to view it within the "Tenets of the Life Cycle":

<u>Tenet 1: Companies go through development growth maturity and decline</u>.

This is true for people, companies, countries and ideas. To understand today's investment landscape it is essential to apply the Life Cycle globally.

Global Life Cycles



The economic idea of Capitalism, which empowers individuals to innovate and create, is in its second wave of growth. Socialism and communism, which promise paternalistic, cradle-to-grave benefits to its citizens through a "managed economy," managed often by corrupt bureaucrats, are in decline. Countries rejecting communism and embracing capitalism have moved from Turn Arounds to Rockets. Countries still mired in socialism are fading towards decline. During the 1980s, the U.S.A. experienced a rebirth of Capitalism by deregulating several government-controlled industries and cutting taxes on income and capital gains. The result has been a steady improvement in economic returns and the record profitability we are witnessing today.

Tenet 2: In the competition for capital, winners and losers are constantly shifting.

Free markets are Darwinian. Genes compete for life and must mutate to survive an ever-changing environment and competitive landscape. Companies compete for capital and must mutate/innovate in order to survive in an ever changing economic environment. Only companies that adapt to a changing environment will survive. This quarter, we witnessed the bankruptcy of Dana Corp and major restructuring by GM, Ford and Delphi in desperate attempts to survive. Struggling to compete are the big "vertical companies" which design, produce and sell. Their survival depends on having the best business processes, competitive products, an appropriate capital structure and flexibility to transform towards the most efficient business model and best practices.

"Platform companies" are the latest corporate mutation gaining ground in the competition for capital. According to GavKal Research "The new business model is to produce nowhere, but sell everywhere…Platform companies keep the high added value parts of research, development, treasury and marketing in-house, and they farm out all the rest to external producers." The emergence of the platform company business model blows away the competitive advantage associated with "bigness." Size was a requirement for the old vertical design business model, but size may no longer be an advantage and could quite possibly be a disadvantage as project lives get shorter and the competitive landscape shifts more rapidly. Could this be why small companies continue to outperform large companies despite their relative overvaluation?

Tenet 3: Over the long term, economic returns approach the cost of capital.

This is an axiom. If it were not true, all companies above the cost of capital would have infinite value. High returns must eventually fall down towards the cost of capital. Low returns must eventually rise up towards the cost of capital. This is true for global economies as well. It is very interesting that during the 1970s, the United States had very low returns and a high cost of capital, while Japan had high returns and a low cost of capital. Today, the U.S.. has high returns and a low cost of capital, while Japan has low returns and a high cost of capital. Japan used to comprise some 40% of the global capital market, while today it accounts for about 12%. Today, the U.S. makes up almost 52% of the global capital market. How high can it go? Might we be at an inflection point where Asia and the U.S. trade places again? Has anyone noticed that the Japan Nikkei has quietly outperformed the S&P 500 for the last 18 months?

Tenet 4: Individual company winners and losers are those that deviate from the markets expectation of Life Cycle fade OVER THE LONG TERM.

This is our favorite! The market understands Tenet #3 and therefore prices a fade to the corporate average. When a company fades down slower than what investors expect, the shares outperform. When a company fades up faster than investors expect shares outperform. We believe we have a portfolio of fade beaters, which will result in significant outperformance. Most investors have been expecting profits and growth to peak, which might explain last year's low returns. However, this quarter demonstrated that companies continue to deliver record results. This is the 15th quarter in a row for companies reporting double digit profit growth. Small companies are "beating the fade."

Tying this all together, we think we better understand the anomalies that have been puzzling us over the last couple of years. Here it goes.

The failure of communism left a void filled by the success of Capitalism. China is moving towards its own version of Capitalism and believes its destiny is to be the next world superpower. China needs the U.S. consumer to achieve this goal. China cleverly pegged its currency to the U.S. dollar so that it would maintain its labor cost advantage regardless of how many dollars the Fed prints, which has resulted in large trade deficits. Japan is a second derivative beneficiary of China's hyper-growth and is awakening from its 20+ year nap. China and Japan recycle trade dollars back into the U.S. via the purchases of U.S. Treasuries *keeping U.S. rates artificially low*, which stimulates the U.S. economy and therefore global economic growth. U.S. companies adapt/mutate/innovate to survive in the new increasingly global competition for capital. These companies figure out how to compete by outsourcing and directing workflow to where it can most efficiently be produced, enabled by a digitally networked world. This has resulted in an explosion of outsourcing and the emergence of the "Platform" company. <u>The consequence of this virtuous cycle of growth is lots of liquidity, artificially low interest rates and an ever widening U.S. trade deficit.</u> The U.S. government continues to print dollars to cover both trade and fiscal deficits, which normally causes inflation. However, because of productivity increases and global competition, companies can't/don't raise prices on goods and services, and, therefore, inflation does not show up in the CPI and other government inflation statistics. However, inflation is a "monetary" phenomenon. While inflation may not be expressing itself in consumer prices, it is upon us and is expressing itself in other markets, mainly the commodity markets (gold, silver, oil, copper, and nickel) and eventually the price of labor in cheap labor countries. In other words, *the U.S. is exporting inflation and importing deflation.* So what does all this mean for small companies and the relative winners and losers?

This macro environment, which we'll call the China Syndrome, favors Industrials because of strong global economic growth and the infrastructure investments required by emerging capitalist economies. Technology companies benefit too because they are high growth and benefit from an artificially low cost of capital. Also, companies must continue to invest in productivity enhancing technology in order to remain globally competitive. Technology enables "Platform companies." It is positive for Materials because they benefit from the inflation that the U.S. is exporting. While the China Syndrome does not directly benefit Healthcare companies, they still benefit indirectly from an artificially low cost of capital because they tend to be high-growth companies.

However, U.S. consumers are showing signs of fatigue. Like a good crack dealer, China has its customers addicted. The customer is the U.S. consumer and the crack is debt. For a while, the China syndrome benefited U.S. consumers by helping them recapitalize their balance sheets, as every homeowner in the U.S. refinanced his house at lower interest rates. This had the stimulative effect of reducing his/her interest burden and improving cash flow. In addition, the consumer realized when refinancing their house, "Wow, I made a lot of money on my house! Why don't I increase my mortgage and take out my gain to put on an addition on my house, buy a Hummer, buy a second home, or take a trip to Vegas!" But, debt is a double-edged sword. It is great when invested in productive assets that earn a return above the cost of capital, but it is not so good when used to consume something with a finite life, especially when you have to keep paying it off after what you have consumed is gone. So, while it was one heck of a party, consumers appear to be a little tapped out as the Fed takes the punchbowl away by increasing the Fed Funds rate. Over $1 trillion of adjustable rate mortgages are set to adjust higher over the next 18 months. The environment for Financials is also deteriorating as profits get harder to generate in a flattening yield curve environment. Utilities get left behind because they are boring, and their yields become less attractive in a rising interest rate environment.

Now what?

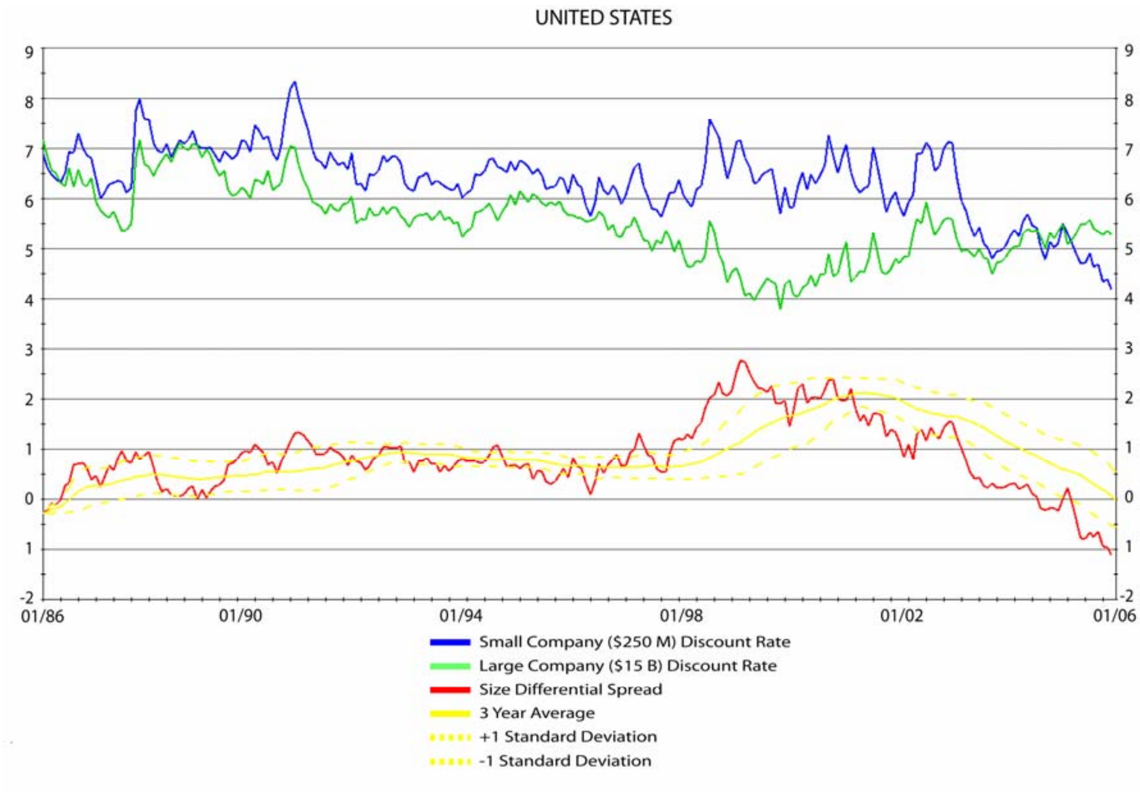
Outlook:

Whether propped up by Asia or not, the current environment is positive. Strong global growth rates and the spread of freedom and Capitalism around the world is resulting in record levels of profitability and growth. U.S. companies are beating the fade resulting in wealth creation. However, we are mindful of Tenet #3, that over the long term economic returns fade towards the cost of capital, and we wonder "How long can the current record spread last?" China's and Japan's willingness to continue to fund the U.S. twin deficits is keeping a lid on inflation and interest rates for now. This virtuous cycle of growth will continue until it ends. We don't know when it will end, but we are nearer the end than the beginning because 1) we have finally figured it out, and 2) our data has been flashing warning signals for the last 24 months. How will we know when it ends? The market will tell us, but for now here are some of the things we are monitoring:

1) **Changes in the spread between CFROI and the discount rate.** So far this continues to widen, which is bullish.
2) **Inflation pressure.** This is the biggest risk right now. Gold, commodities, economic growth continue to signal inflation pressure which the bond market, due to artificially low rates propped up by Asia, refuses to recognize. If we have figured this out, the Fed must have figured this out and is likely to keep increasing rates further than the market currently appreciates. Neutral for now.
3) **Monetary policy in Asia.** Japan and China own a huge chunk of U.S. debt. Japan, in particular, has invested in U.S. Treasuries because there was nowhere else to put their dollars since there has been hardly any growth in Japan for the last 20 years. Might that be about to change now that Japan is growing again? Japan's recovery could be the catalyst that removes the artificially low rates in the U.S.
4) **Protectionism.** Congress scuttled the sale of U.S. ports to Dubai. Senator Schumer's solution to the China peg to the dollar is a big tariff on goods imported from China. Neutral for now but this bears monitoring.

Strategy:

Most of our concerns are related to the denominator of our valuation model, which we can't do much about. Additionally, our strategy is long term and we expect there will be times when the market gets a little overvalued and a little undervalued. This appears to be one of those times when small companies in particular look a little overvalued relative to some of the risks on the horizon.



Source: CSFB HOLT ValueSearch™

Since risk premiums are nonexistent, we believe this is not a time to take on additional risk in the portfolio. Therefore, we are modestly overweight the relatively less risky Corks and Golden Goodies and underweight the more risky Rockets and Turn Arounds, resulting in a lower beta of about .97. We are using the current speculative environment to lighten up or sell fairly valued riskier companies like OSI systems and buy companies such as Strayer Education, which have higher quality managements with less variability in CFROI and growth in their business models and good long term growth prospects. We are also looking to buy washed out companies such as Affymetrix, where long-term growth is very attractive but where investors have given up due to near term earnings difficulties. We believe these actions are prudent given the current environment in which it is getting more difficult to find value in smaller companies.

Offsetting discount rate concerns is the strength we see in the numerator, which must be respected. Additionally, private equity is chock full of cash and is on a shopping spree. Several of our companies were bid for, or were the subject of takeover speculation this quarter including Jamdat, Duratek, Longview Fibre, Calloway Golf, and Source Interlink. Being a little more conservatively positioned might cost us some relative performance in the near term, but we believe it is in the long term that our clients will appreciate our effort to hold on to the 17% compounded annual growth we have been able to generate over nearly 7 years.

Thank you for your continued support.

Kind regards,

Christopher C. Faber
IronBridge Capital Management, L.P.