IronBridge
Capital Management, L.P.

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First Quarter 2007 Small Cap Core Review

> "Fremont General Corp. said a regulatory order will require it to stop giving mortgages to people who can't repay, and it plans to get out of the subprime home-loan business."
>
> - Bradley Keoun, Bloomberg Press

Dear Fellow Investor,

Stocks posted a modest gain for the first quarter of 2007. The Russell 2000® Index increased 1.95%. We are pleased that our Small Cap Core product increased over 5%[1], significantly beating the benchmark. Although volatility remained high, and February brought on quite a scare with an 8.3% correction in the market, the product performed well in both the rising and falling markets.

Investors digested several mini tremors this quarter including the Chinese government's announcement to reign in speculation, the weakening dollar's potential to break the Yen carry trade and, of course, the subprime mortgage meltdown. A few clients have asked us if we thought the subprime mortgage lending meltdown could be the warning tremor before a much bigger quake. We doubt it, but we do not know for sure. What we do know is that the capital markets are doing their job by taking players who are not good stewards of capital out of the system.

Several mortgage lenders were not good stewards of capital and visibly violated basic laws of finance. Lending, like all financial activities, conforms to certain laws. A loan should only be made when the lender, through due diligence, can demonstrate a high probability that future net cash receipts will be sufficient enough to pay back principle and interest. Some mortgage lenders tried to circumvent this basic tenet of finance by abandoning proper due diligence into the borrowers' abilities to repay and instead substituted computer-driven FICO scores.

[1] Past performance does not guarantee future results. Returns reflect reinvestment of dividends, gains, and other earnings.

These lenders reduced costs and increased profitability associated with loan originations. By selling pools of newly originated mortgages into the structured finance marketplace, these mortgage lenders freed up capital to originate more loans. This circle of events created a business model in which profitability was driven by structured finance managers' appetite for new pools of mortgages and the availability of more (read less qualified) borrowers. Indeed, the appetite for new mortgage pools soared in recent years. In a form of modern day alchemy, financial innovators have profited through the transmutation of risky subprime mortgage pools (lead) into highly-rated debt instruments (gold). This transmutation is accomplished through an elixir of diversification, segmentation, and prioritization based on historical statistical trends in default and foreclosure data. The transmutation proves illusionary when investors realize that current default risk patterns are not consistent with past trends because the lending practices that underlie the statistics have fundamentally changed.

Lesson: The fundamental laws of finance will always prevail, and the subprime meltdown is just the market's way of reminding investors to respect the laws of finance. Risk exists. You can not repackage it, sweep it under the rug, or make it disappear. Our disciplined CFROI®[2] valuation framework is a constant reminder to us to respect the laws of finance. It certainly paid off this quarter!

First Quarter Attribution:

The Small Cap Core product outperformed the Russell 2000® Index by approximately 300 basis points, which is at the higher end of what we would expect from any given quarter. Several factors at play contributed to what we consider an excellent quarterly result. Stock selection contributed nearly 90 percent of the excess return, while sector allocation contributed to the balance of the outperformance.

Stock selection was particularly strong among the Health Care, Industrials, Energy, Information Technology, and Financials sectors. Stock selection was also boosted by the fact that two companies in the portfolio were bid for: MapInfo (+54%) & Aeroflex (+12%). Stock selection was weak among our Materials holdings. The Materials group was up 11% on the back of a wave of takeovers and takeover speculation among steel stocks and a surge in commodity-based companies. While we own some commodity-based companies, the majority of our Materials holdings are heavily weighted towards chemical names, which simply could not keep up.

The sector allocation's contribution to relative performance was derived mostly from being underweight to our maximum risk limit in Financials. Financials were negatively impacted this quarter by subprime lenders' woes, a noticeable deterioration in credit quality, and narrowing net interest margins not reflected in earlier valuations.

[2] CFROI is a registered trademark in the United States and other countries (excluding the United Kingdom) of Credit Suisse or its affiliates.

Beneath the attribution analysis, there is something else at play that we have been monitoring for quite some time. This quarter, the out-of-index small companies (between $200 million and $2.5 billion) outperformed the Russell 2000 by approximately 400 basis points. Given that our portfolios have 30% of their holdings outside of the Russell 2000, the product gained approximately 120 basis points from this tailwind. This trend begins to reverse out last year's 180 basis point headwind, which was a result of out-of-index stocks underperforming the Russell 2000 by 600 basis points. We are certain that this phenomenon partially contributed to the mass underperformance of small cap active managers in 2006. We knew that certain fundamental laws of finance meant this phenomenon was not sustainable, but we did not know when we would be rewarded for our patience and discipline. We are grateful, as are our clients I am sure, that we were rewarded sooner rather than later.

Skip this section if you only care about this quarter's performance; read if you are intellectually curious…

Ubiquitous Capital Markets:

While on spring break, I read a fascinating book. *Ubiquity* by Mark Buchanan, takes the reader into the world of complexity theory. The book highlights several interesting concepts related to the unpredictable nature of earthquakes, forest fires, animal extinction, outbreaks of war and other really fun stuff. At least it is fun for those of us who operate in a world where we are constantly trying to gain excess return for our clients while being mindful of constant, unpredictable risks that are lurking around every corner. Some of the concepts in the book helped me to think more deeply about many of the anomalies we have been observing in the capital markets as of late. In addition, those same concepts helped me further realize just how valuable IronBridge Capital Management's unique dual diversification approach to risk control is to our clients.

The question the book seeks to answer is, "Why don't ecosystems, organisms and economies reveal the same simplicity as Newton's laws and the other laws of physics?" The answer is that laws of physics live in a state of equilibrium, while dynamic systems are constantly in a state of flux. The author describes this state of flux as the "critical state" or disequilibrium, which is characterized by frequent disruption varying from barely visible to large upheavals (including tsunamis, large earthquakes, depressions, wars, stock market crashes), which are, thankfully, very rare when measured over the average human being's lifetime.

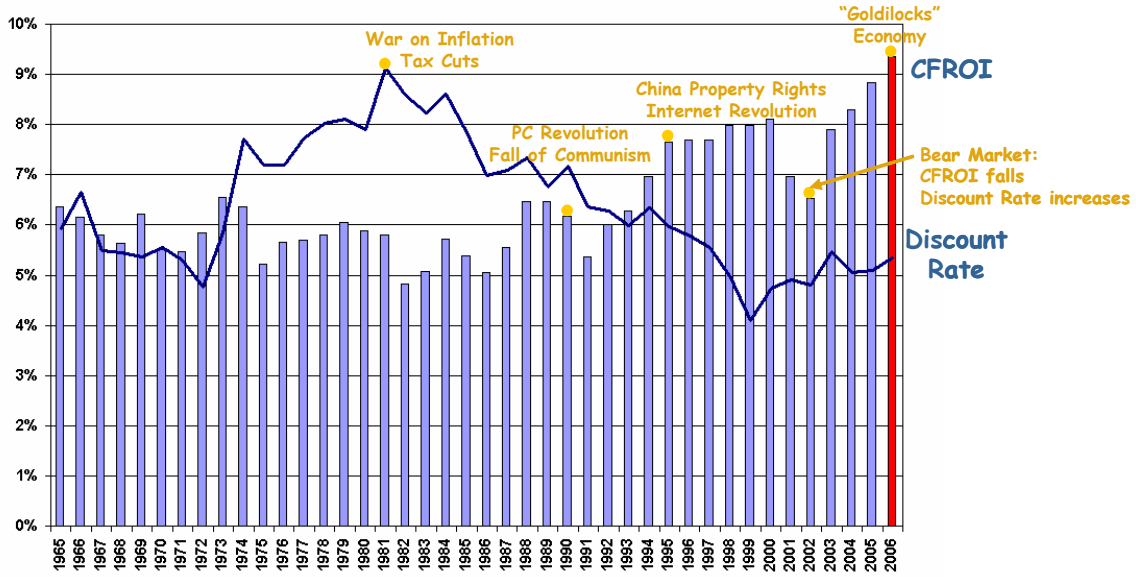
The study of complexity theory is done through the sand pile game where scientists drop grains of sand over and over to create a sand pile until one grain triggers an avalanche. Scientists observe that there are no laws of physics that predict how high the pile can grow. No laws can predict which grain will cause the avalanche. No laws can predict whether the avalanche will be big, average, small or virtually unnoticeable. Predicting outcomes of the sand pile game is impossible.

So what is the point of the game? Scientists have learned a few concepts about ecosystems and economies that are relevant to understanding capital markets. Many of the concepts in

the sand pile game used to study complexity theory bear a remarkable resemblance to IronBridge's innovation of looking at valuation as the expected return of several potential outcomes while leveraging our research of fade distributions.

Lessons of the Sand Pile Game:
History can never be washed away. It affects the future of dynamic systems. There is no such thing as a typical pattern (history never repeats, thereby making the future unpredictable). Each grain of sand dropped represents a historical event. As the grains collect, they organize into a unique critical state riddled with "fingers of instability" of all possible lengths and sizes. Tension grows. Eventually, one of these fingers of instability slips and gives way. Depending on the size and length of the complex network of fingers of instability, anything can happen as the physical laws of gravity interact with the critical state of the pile. This forms a new base from which the sand pile grows larger before the next "adjustment."

Can lessons of the Sand Pile Game help us gain insight into why the spread between the CFROI and the Discount Rate has defied history?



Source: Credit Suisse HOLT

1) History can never be washed away, and it affects the future of dynamic systems:

There are millions of tiny grains of sand in the pile and millions of tiny historical events that have brought us to our current state in which CFROIs for the United States are at historic highs while the discount rate remains extremely low. Below is a list of some of the big grains of sand that have dropped over the last several years.

> **1980**: Ronald Reagan's tax cuts, military build up, and Paul Volker's war on inflation starts in motion a secular decline in the cost of capital and accelerates the fall of communism.

1986: Big Bang kicks off deregulation of global capital markets and sets into motion lower trading costs, freer-flowing capital, and a convergence of global cost of capital.

1990: The fall of Communism creates an economic void among communist countries. Japan's stock market crashes, setting it on a path of deflation. The PC revolution begins with WinTel (Microsoft/Intel) setting the stage for decades of increases in productivity leading to higher levels of CFROI.

1995: The Internet Revolution ignites a wave of speculation, but it also transforms business productivity and sets the stage for the emergence of the "Platform Company," a company whose essential functions are connected anywhere in the world where it can be most efficiently produced. Mao declares "profits are good," which decidedly moves China towards capitalism, filling the economic void from the fall of communism.

1998: Chinese property rights take hold.

1999:
Zero Interest Rate Policy (ZIRP) is adopted by the Bank of Japan to break the deflationary spiral. This action sets the stage for the yen carry trade, where yen are borrowed virtually for free and converted into stocks, bonds, commodities, alternatives, and REITs. The water begins to flow, eventually becoming a flood of liquidity around the world by 2006.

Vanguard overtakes Fidelity in assets under management as indexation gains significant market share over active management. Mass adoption and use of QQQs and OEXs sets the stage for a mega cap bubble as capital inflows ignore net cash receipts in favor of size. This phenomenon creates a size/momentum strategy, sending share prices of mega-cap stocks into the stratosphere. The insanity of the resultant market valuations was captured in HOLT's discount rates which highlighted a 1% discount rate to justify the valuation for Cisco.

2000: The Nasdaq/mega-cap markets crash when the size/momentum-based strategy associated with the popularity of indexation runs out of gas. Share prices of mega caps fall until active buyers step in to purchase. How did they know when to buy? That's easy. Buyers step in when the price is equivalent to present value of future net cash receipts. Eventually prices will always fall in line with the present value of future net cash receipts.

2001: The United States is attacked by Al Qaeda on 9/11. The Fed pumps massive amounts of liquidity into the system to avoid a recession.

2002: U.S. and coalition troops go to war in Iraq. The greatest bear market since the Great Depression sets in as CFROIs fall from 8% to 6.5%, and the discount rate rises from 4% to 5.5%. The sell-off generates growing interest in risk management tools

and diversification, which spurs wider systematic adoption of derivatives, credit default swaps, hedging techniques, hedge funds and commodities futures to better manage risk. The view of looking at markets as baskets of risk to be managed using models based on historical price correlations gains in popularity. Global liquidity from the yen carry trade, plus Fed cuts, plus allocations from stocks to alternative asset classes for diversification purposes, sets the stage for the housing, REIT, private equity and commodity bubbles.

2003: President Bush's tax cuts ignite a new bull market. Global growth takes hold as growth in economic freedom, lower taxes, and emerging markets follow China's lead with their adoption of capitalism.

2004: The "Goldilocks economy" emerges. Global growth, combined with low inflation, drives rapid increases in profitability as U.S. and China's jobs-for-profits trade kicks into high gear.

2005: The Goldilocks economy continues. Housing and commodity prices blow off to the upside. ETFs and other structured products proliferate as investors can not get enough of these cheap baskets of risk to help manage the efficiency of their portfolios. Hedge funds, private equity funds, commodity funds, REIT funds and small cap funds have buckets of cash fall in their laps due to their favorable position in the output of mean variance optimization models. Derivatives and alternative investments continue to gain popularity among investors seeking higher risk-adjusted returns. Systematic leverage increases due to overconfidence in risk management tools. The Fed tries to drain liquidity by raising rates, but they are unsuccessful due to changes in the structure of global capital flows. China, Japan, and increased leverage pump more liquidity into global markets than the Fed can drain out.

2006: Barclays Global Investment becomes the largest asset manager on the back of explosive growth in ETFs and quantitative strategies. Democrats take control of the U.S. Congress. Bill Sharpe, a risk optimization pioneer, rethinks risk management tools. He recognizes several flaws of the mean variance approach including "long-tail risk," economic shocks, liquidity and taxes. We totally agree and would add human risk, which occurs when a false sense of security leads to reckless behavior, such as that recently witnessed among the subprime mortgage lending community.

2007: The housing bubble finally bursts. Several subprime lenders go bankrupt. China enacts rules to curb speculation. The dollar's weakness threatens to break the yen carry trade. Record-breaking private equity deals. Zell sells his REIT. BlackRock goes public.

Which brings us to the end of the first quarter 2007…

2) The Critical State of the Market:

CFROIs exceed the cost of capital by a margin, not witnessed in many years, driven by the forces of Globalization, Technology, and Financial Innovation. Widespread adoption of free trade, combined with the productivity benefits of technology, has ignited the greatest expansion of global growth and wealth in history. Technology and financial innovation allow capital to roam the world in search of the highest returns. New tools for risk controls have allowed risk premiums to fall, resulting in a lower cost of capital. However, a lower cost of capital results in lower expected returns on financial assets, which presents a challenge for those who have large unfunded future liabilities requiring higher returns. The need for higher returns has ignited demand for alternative investments such as private equity, real estate investment trusts, commodities and hedge funds.

Another consequence of globalization is the growing popularity of the yen carry trade. Japan's ZIRP policy has meant that capital is essentially free to borrow from Japan. Given the Japanese government manages the value of the yen within a certain range, currency risk is minimal, and savvy global investors borrow in yen and invest in all other asset classes. These investors utilize the latest and greatest structured products offered by Wall Street, which provides "liquidity to illiquid asset classes" and utilizes mean variance optimization to seek the highest risk-adjusted returns. This is now a very crowded trade. Perhaps that is why, when the market cracked in February, the benefits of diversification failed to appear. Gold, commodities, large-cap stocks, small-cap stocks, and bonds all fell, which is not predicted by mean variance optimization tools. It almost looked like all asset classes, particularly those asset classes that have a lot of structured product tied to them, have become correlated to the yen, and there was a breakdown in their historical correlations.

The current critical state of global markets is more complicated than it has ever has been. The sheer magnitude of global capital sloshing around the world, combined with all the different players that have popped up in hedge funds and investment banks, and all the different financial instruments designed to slice and dice risk in so many different ways to meet different buyers' needs, has indeed grown to form a complex network of fingers of instability.

3) Fingers of Instability

There are too many fingers of instability to list and their relationships are too complex to truly understand. Sure, there are a few obvious ones to watch like the subprime meltdown and whether it spreads into the general economy, or how the newly elected Congress might respond to the huge wealth inequality generated from the global boom, or the effects of the jobs-for-profits trade with China and whether Congress may be tempted to deal with the issue through protectionism. There is the possibility that the Chinese government might clamp down harder on speculators, sending ripples through the global economy, or that Japan's currency suddenly strengthens dramatically, breaking the yen carry trade. However, these are just the obvious ones. The fact that they are so obvious might make them less likely to cause a major "quake."

4) The Nature of the Sand Pile

The nature of the sand pile is that eventually one of the fingers of instability gives way, but, most of the time, adjustments are small rather than a large. Small adjustments are necessary and allow the pile to grow higher without a major avalanche. The subprime sector is an obvious "adjustment," which we hope will be a minor, but necessary, force allowing the markets to grow higher. As investors, every so often, we should expect adjustments like the 8.3% adjustment we experienced in February. Another observation in the sand pile game addresses the issue of frequency and magnitude of adjustments called the Power Law. The Power Law that emerged from the sand pile game also emerged in the study of earthquakes, forest fires and stock market crashes. It says that for every doubling of the size of the adjustment the odds are four times less likely. Phew!

5) Relevance of the Sand Pile Game to the IronBridge Investment Approach

In the sand pile game, the interaction between physics laws (gravity) and dynamic systems (sand piles) is similar to the world in which we operate. We rely heavily on financial laws to make our investment decisions. The most important financial law is that the value of a business is the present value of expected net cash receipts. Through our Life Cycle lens, we understand the dynamic nature of markets, and we constantly try to understand how the world around us is changing and how that change might impact our stocks and the portfolio. Though we seek to understand, we also know prediction is a dangerous game. We have built tools to help us get an edge over our competition that, at least, tell us when the odds are in our favor. Nevertheless, the investment world is a risky place, and we respect that fact. Our unique risk control tools of diversification across Life Cycle and industry also pay respect to the fact that the future is unpredictable. This approach helps us survive when unpredictable events happen, such as oil going from $25/barrel to $80/barrel.

We are certain that financial laws must be obeyed over the long term, even if in the near term structural changes force prices to temporarily violate these laws. For example, in the year 2000, no one could predict how far the Nasdaq or mega-cap bull market would go nor when valuations would begin to obey financial laws. We remember being laughed at and told that we "just don't get it" when the Nasdaq was at 3000, then 4000, and then 5000! As of April 11, 2007, it stands at 2447. But as certain as we know the sun will rise again tomorrow, we know that the value of the company will always reflect the present value of future net cash receipts. Those who ignore these laws are destined to go the way of the subprime lenders.

Outlook:

Stock market volatility will likely continue with rapidly changing sector and Life Cycle leadership, continued M&A activity, continued demand for illiquid assets (driven by optimization models) and the need for pension funds to earn higher returns than those perceived available in large-cap stock and bond markets.

Investors will continue to try to sort out whether the economy is headed for a soft or hard landing. They will monitor the housing, subprime mortgage markets, and derivative markets for any hint of systematic risk or contagion in the overall economy. Investors will try to understand the agenda of the newly elected Democratic Congress and sort out what this might mean for investor taxes, affects on certain industries, and even protectionism as a solution to the China peg. Investors will try to get a handle on the liquidity-driven market, constantly guessing as to its sustainability. This ongoing deliberation will cause adjustments that our disciplined framework will take advantage of by allowing us to invest in companies that are doing the right thing to create shareholder value and that are selling at a discount to the present value of the expected net cash receipts.

Our disciplined Life Cycle and industry diversification should help us add value through stock selection as we navigate an unpredictable future.

Thank you for your continued support.

Kind regards,

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