



April 2008

***IronBridge Capital Management, L.P.  
First Quarter 2008 Small Cap Core Review***

*“Liquidity is a function of laziness. By this I mean that liquidity is an inverse function of the amount of research required to understand the character of a financial instrument.”*

*Peter Bernstein*

Dear Fellow Investor,

Stock prices fell hard during the first quarter of 2008. The Russell 2000<sup>®1</sup> Index fell 9.90%. Our Small Cap Core product held up relatively well, falling approximately 8%<sup>2</sup> (gross of fees) during the first quarter. There was nowhere to hide as the unwinding of financial “sinnovation” continued to put downward pressure on financial assets and stock markets around the world.

We are not surprised. Our cautious outlook in last quarter’s commentary was based on the clarity that “the self-correcting mechanism of capitalism has more work to do to clear out the poor allocators of capital.” That self-correcting mechanism was very busy during the first quarter of 2008 as poor allocators suffered the penalty of wealth destruction and fell into the arms of better stewards of capital. Bear Stearns collapsed into the arms of JPMorgan. Countrywide Financial collapsed into the arms of Bank of America. Regulators cleared the way for Warren Buffett and Wilber Ross to enter the municipal bond insurance business as incumbent firms floundered under the sub-prime crisis. Several high-profile hedge funds collapsed in spectacular speed and fashion.

While the unwinding of financial “sinnovation” increases market volatility, it also increases long-term opportunity for those who understand the importance of proper capital allocation.

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<sup>1</sup> Russell 2000<sup>®</sup> Index is either a registered trademark or tradename of Russell Investment Group in the U.S. and/or other countries. Indexes are unmanaged and cannot be invested in directly.

<sup>2</sup> Return is gross of fees. Past performance does not guarantee future results. Returns reflect reinvestment of dividends, gains, and other earnings.

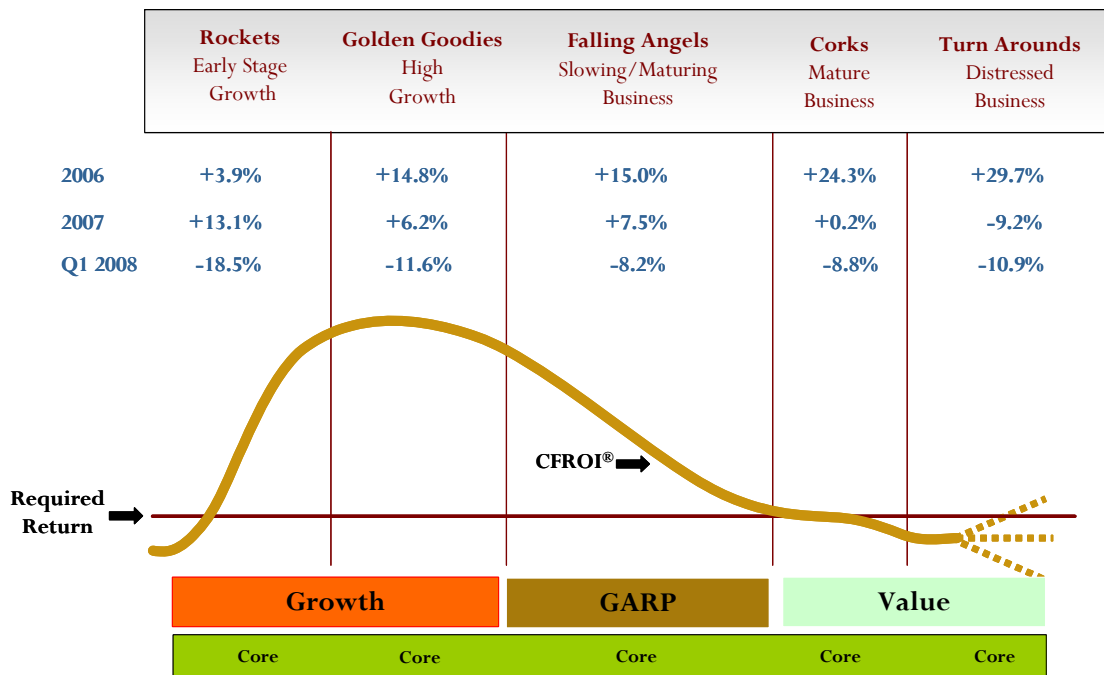
## First Quarter Performance Attribution

During the first quarter of 2008, the performance of the Small Cap Core product fell nearly 8% compared to 9.90% for the Russell 2000 Index. Stock selection drove approximately 200 basis points of excess return. Stock selection was particularly strong among our Consumer, Energy, Health Care and Information Technology names, but weaker among our Industrial holdings. The sector allocation's contribution to relative performance was derived mostly from nearly 5% cash.

While market volatility is unnerving, it also offers opportunity to buy good companies (skilled allocators of capital) at very attractive long-term entry points. Taking advantage of anticipated volatility was the focus of our team as we scoured the new annual data of hundreds of companies and bought eleven new names. We are pleased to report that ten of the eleven new buys not only outperformed the market and their industry group, but posted a positive absolute return.

From a Life Cycle perspective, Rockets and Golden Goodies experienced the greatest price decline during the first quarter. Our thesis that growth should outperform value has not worked this year and reminds us why Life Cycle diversification is so important to risk control. Perhaps the severe underperformance of Rockets is telling us that the unwinding of financial sinnovation will make access to capital more difficult or more expensive. Or, perhaps since Rockets are the fastest growers, and general growth expectations are falling, the net present value of future growth is more sensitive than the rest of the market. We do not know for sure, but we are glad to be diversified.

## Life Cycle Returns – Russell 2000<sup>®</sup> Constituents by Life Cycle



CFROI<sup>®</sup> is a registered trademark in the United States and other countries (excluding the United Kingdom) of Credit Suisse or its affiliates.

Source: IronBridge Capital Management, L.P.

## The Great Unwind

The self-correcting mechanism of capitalism is correcting for the sins associated with a widespread misallocation of capital, which resulted from the universal adoption of flawed risk models. These “innovative” risk models fueled a change in the structure of lending from a principal to an agency model. The principal model was hard work, because it required old-fashioned thought, prudent analysis, and adherence to principles such as lend only to people who have the capacity to pay you back. The agency model was easy because it only required technology, historical data, and lots of borrowers coupled with algorithms created by smart people to be widely adopted by “lazy” people (lazy is Bernstein’s word, not mine).

The transition from the principal to the agency model was propelled by perceived tax and risk pooling advantages of “Debt Securitization” (the pooling and repackaging of cash-flow producing financial assets into securities that are then sold to investors). We do not want to sound too old-fashioned. We certainly appreciate that there are benefits to society from the securitization of credit. A benefit to society of securitization is that it increases liquidity, which drives down the cost of capital, which drives more investment and growth.

However, you can have too much of a good thing when lenders lose sight of their role as stewards of capital. Blinded by the lopsided nature of the incentives and tax policy, debt securitization grew too big, which drove too much liquidity and resulted in a “disappearing risk premium,” which left asset valuations vulnerable to a systematic mispricing of risk and a systematic misallocation of economic resources. Another flaw of too much securitization is the impact it has on human behavior, which resulted in “laziness” and widespread lending to individuals and entities that had very little chance of paying the money back. While securitization was expanding liquidity, other financial innovations (ETFs and credit default swaps) exploded onto the investment scene and helped create liquidity where little existed.

All of these new “securities” required better risk management tools, which perpetuated the adoption of “Value at Risk” (VaR) models. All of these new financial innovations and risk management tools led to overconfidence in the form of unsafe debt levels. Long-term investors lost market share to highly leveraged speculators who used cheap credit to trade baskets of risk. The concept of investing for long-term wealth creation seemed quaint. A new generation of gunslingers with investment time horizons measured in seconds and quantitative managers who literally did not care what companies produced were garnering more and more of society’s capital. Modern finance lost its way as the concept of capital stewardship gave way to overconfidence in algorithms used to support leveraged wealth transfer strategies. This is how financial innovation morphed into financial “sinovation” and a widespread misallocation of capital.

Our fourth quarter letter tried to point out the important differences between legitimate wealth creation and the illusion of wealth creation, as well as the risks associated with employing leverage to fund the illusion of wealth creation. It seems that even Wall Street’s “Masters of the Universe” are no different than the financially illiterate, overextended home borrower when it comes to understanding the difference. Now, the self-correcting mechanism of capitalism is teaching them hard lessons by exposing multiple flaws associated

with securitization and backward-looking risk models. The first to heed the lesson was Merrill Lynch by completely exiting the collateralized debt obligation (CDO) market. Others will surely follow. Some of Wall Street's "risk managers" have pronounced the "death of Value at Risk models," which is a little scary considering the Basel II accords mandated the use of Value at Risk models to establish equity requirements for the international banking system. What now?

If you are a driver worried that your brakes might fail, you slow down. If you are a capital provider worried that your risk model is flawed, you reduce leverage. In the world of finance, you call in margins, which is what is happening right now. The realization that twenty years of increased liquidity were built upon flawed models of securitization and risk management is rapidly going into reverse. This is what we have termed the great unwind.

### **The Cleansing Process Has Begun**

Securitization has ground to a halt. Margins are being called. Those who have leveraged investment into illiquid assets are the first to fall. The list includes the Carlyle Group, Bear Stearns, Countrywide, Fremont, Thornburg Mortgage, several hedge funds and over fifty mortgage lenders. The largest global banks are seeking capital infusions to avoid being the next to fall. In the first quarter of 2008, the largest global banks required \$136 billion in emergency capital infusions (mostly from sovereign wealth funds).

The cleansing process, once begun, is often painful in the near term but opportunistic in the long term. When complete, the poor allocators of capital will no longer have a seat at the table. A few may even end up behind bars. Regulators will try to figure out what went wrong and what to "do" to keep this from happening again. What seems clear is that we are at a moment of transition in the financial markets and in financial thinking. It is unclear to what we are transitioning. How will the failure of the agency model affect the structure of lending? What new financial regulations will emerge? How will the failure of risk models affect portfolio structures? How will global liquidity be affected by all of the above? How many more players will fall?

Meanwhile, markets will be volatile – falling while poor stewards of capital fail to deliver on expectations and rising as the government intervenes to try to save them. High volatility will continue to provide attractive entry points for long-term investors who can identify skilled company managements. We hope to take advantage of anticipated volatility so we can buy into long-term wealth creation at attractive prices while others are unwinding their wealth transfer strategies to pay down debt.

Longer term, the economic system should emerge healthier and stronger as its poor stewards of capital are purged.

## Outlook

Last quarter's cautious outlook was justified. We remain cautious this quarter, but we are encouraged that the cleansing process has already begun. This process should ultimately lead to a new era of wealth creation fueled by the benefits of globalization and expanded adoption of free markets around the world. Indeed, risk appears to be more realistically priced today, removing one of our concerns regarding market valuations. This is a great time to be investing for the long term. However, near-term uncertainty remains high. Global growth is slowing. Economic profitability and growth is decelerating from unprecedented highs. The de-leveraging process is causing violent price moves in all markets. Additional potential victims of leveraged wealth transfer strategies are lurking in the non-transparent world of hedge funds, investment banking and banking. Many headwinds make absolute returns elusive in the near term.

Our simple view is that many market participants confused transfers of wealth with long-term wealth creation. It is only the business models built around long-term wealth-creating strategies based on the allocation of productive capital that will prove permanent and will flourish in the future. We remain confident that our disciplined investment approach and internally-developed investment tools will help us identify these businesses and position the portfolio to benefit from the eventual recovery in capital markets.

Thank you for your continued support.

Kind regards,

A handwritten signature in black ink, appearing to read 'Christopher C. Faber', written in a cursive style.

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

## Small Cap Core Equity Composite

April 30, 1999 to December 31, 2007							Assets & Returns in USD	
Year	IronBridge Gross Return %	IronBridge Net Return %	Russell 2000® Return %	Number of Portfolios at End of Year	Composite Dispersion	Total Firm Assets End of Period \$ Millions	Total Assets in Composite \$ Millions	
1999	19.50	18.70	17.67	<5	NA	7.9	4.9	
2000	15.19	14.03	-3.02	<5	NA	16.0	11.8	
2001	18.79	17.63	2.49	<5	NA	24.6	20.8	
2002	-11.87	12.77	-20.48	<5	NA	61.0	50.6	
2003	48.29	46.85	47.25	<5	NA	521.3	233.6	
2004	19.84	18.68	18.33	22	0.36	1,878.0	1,112.2	
2005	4.35	3.34	4.55	28	0.54	2,692.9	1,343.4	
2006	16.36	15.22	18.37	25	0.35	3,696.4	1,221.9	
2007	10.78	9.68	-1.57	24	0.48	4,429.0	1,169.6	

IronBridge Capital Management, L.P. has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).

- 1 IronBridge Capital Management, L.P. is a dedicated equity manager, and an independent investment management firm that is not affiliated with any parent organization.
- 2 The benchmark is the Russell 2000. The annualized composite return since inception is 15.32% before management fees; 14.18% after fees; and the annualized benchmark return is 8.16%.
- 3 The composite includes all small cap portfolios, invested in companies with relatively small market capitalizations (i.e., generally under \$2.5 billion), with both growth and value attributes. The composite excludes portfolios under \$5 million, and portfolios that are tax-sensitive or have client-driven restrictions. The composite was created on March 31, 2002.
- 4 The inception date of the composite is April 30, 1999. The returns for 1999 for the composite and benchmark include May 1 through December 31 and are not annualized.
- 5 The standard management fee is 1.00% of assets. Net returns are computed by compounding monthly.
- 6 Gross of fees returns are presented after trading expenses, but before all other fees.
- 7 IronBridge uses equal-weighted standard deviation as the dispersion measure.
- 8 Accounts are removed from the composite when significant cash flows occur, for the month of the flow and the month after. Significant cash flows are defined as 50% or more of the account value. Prior to 2007, significant cash flows were defined as "50% of the account value or \$15 million or other amounts IronBridge believes will materially affect performance." The change was made in order to ensure consistency in the application of the cash flow rules. Additional information regarding our cash flow policy is available upon request.
- 9 Derivative use within the composite is minimal and deemed immaterial.
- 10 A complete list and description of all IronBridge composites is available upon request.
- 11 Additional information regarding policies for calculating and reporting returns is available upon request.