



October 2006

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

“Do we really understand what is going on in the derivatives market, a market that in 2005 was 22 times the U.S. gross domestic product?”

- Vito Tanzi, senior consultant to the Inter-American Development Bank

Dear Fellow Investor,

The IronBridge Small Cap Core product was essentially flat for the quarter, compared to a 0.44% increase in the Russell 2000 Index. While the market may not have moved much, the quarter was anything but dull. The potential investment bubbles that our team has been concerned about in housing, energy and commodities have started to deflate. This is positive news for investors because it may result in a lower discount rate and, therefore, higher share prices if inflation pressures start to moderate. However, the countervailing force to this rosy scenario may be a return of “risk premium” in the market and a peak in CFROI[®] and growth.

$$\text{Price} = \frac{\text{Cash Flow}}{\text{Required Return}}$$

Cash Flow { CFROIs at all-time highs (rolling over?)
Growth decelerating (hard or soft landing?)

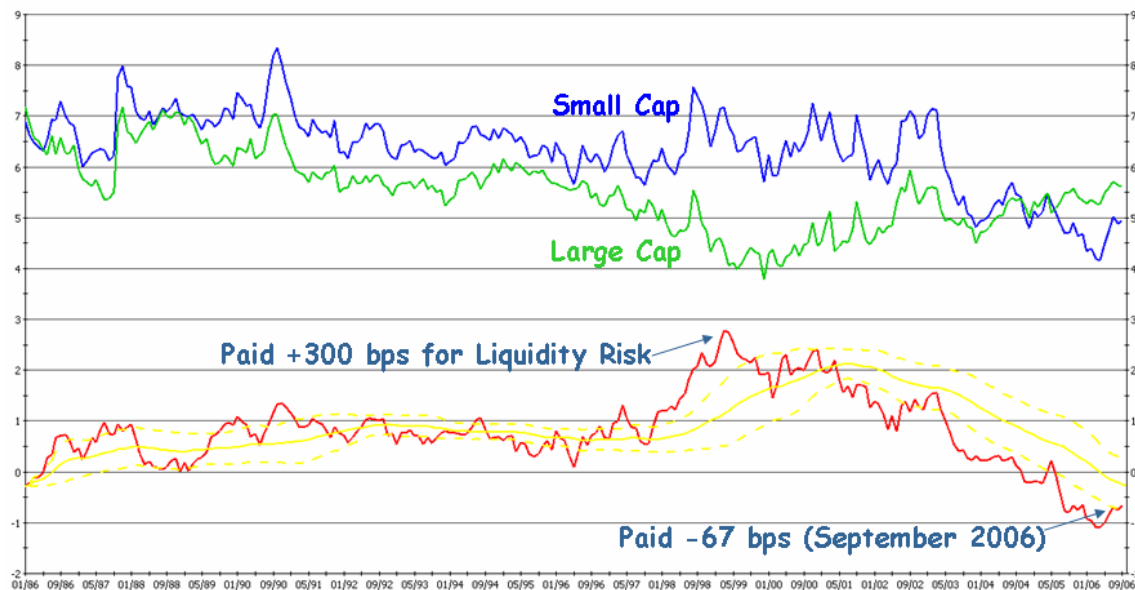
Required Return { Inflation above the Fed's comfort zone
Beginning the return of “risk premium” in market

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

Investors hedged their bets against a hard landing in the third quarter by selling Energy (-8.6%), Materials (-2.6%) and Industrials (-3.8%), while buying recurring revenue stream business models like Telecom Services (+9.9%), Consumer Staples (+4.7%) and Utilities (+7.4%). Investors also demonstrated a strong preference for the safety of large liquid markets like treasury bonds (+6.7%) and large cap stocks (+5.7%).

It is interesting to note that small caps have now underperformed large caps for two quarters in a row. That is the first time this has happened since 1999, prompting some folks to ask whether the market leadership of small caps over large caps has officially come to an end. We do not know the answer.

What we do know is that for the last three years the market seems to have ignored the small cap liquidity risk premium normally demanded by investors. We suspect, however, that at some point in the future, investors will again price small companies with a liquidity risk premium. The liquidity risk premium has historically ranged between 70 and 80 basis points. It is impossible to predict when, or if, the risk premium will return to normal, but we do follow it regularly to monitor risk. Over the last two quarters, the small cap risk premium has increased from -110 to -67 basis points.



Source: Credit Suisse HOLT ValueSearch

Third Quarter Attribution:

Stock selection contributed only modestly during the quarter, while our sector allocation detracted approximately 45 basis points from the relative return profile. An approximate 4% overweight in Industrials and 4% underweight in Financials accounted for the majority of the underperformance during the period.

We are amazed by the strength of Financials in this market. Financials continue to perform well for investors, despite the fact that their operating environment continues to get more and more difficult. The difficulty is evidenced by an inverted yield curve and data indicating that we are at the top of the credit cycle. Additionally, valuations appear rich. Today, the financial sector represents 22% of the Russell 2000 Index, which is the highest representation in the last 10 years. Granted, 53% of Financials reported positive earnings surprises compared to 47% that reported negative ones, but we find it very interesting that 80% of Financials reported positive revenue surprises. The inference is that Financials are trying to make up for lower margins with higher volumes, which could lead to bigger credit problems down the road. We also observed an anomaly: bank multiples historically contract about 17% throughout a Fed tightening cycle, but they did not contract at all during this cycle. Inference: bank multiples may not expand as they have in the past when the Fed starts lowering rates. We remain underweight Financials.

Maybe bank multiples did not contract, but Industrials sure did. Given that the deflating housing bubble is credited for a good portion of the anticipated slow down in economic growth, we were surprised by the relatively poor performance of Industrials versus Consumers and Financials. In contrast, the industrial companies we own or follow have yet to report a slowdown in business activity. Their biggest complaint has been the high cost of energy, which is becoming less of a headwind going forward. Granted, it is clear that the economy is slowing, but it seems to us that businesses exposed to highly leveraged consumers might get hit harder than cash-rich industrial companies. We continue to see more value among the cash-rich Industrials and think our holdings have a pretty good chance of surprising the market on the upside. As a result, we remain overweight Industrials.

Stock selection was very strong among our Health Care, Materials and Consumer Discretionary sectors but weaker among our Energy, Industrials and Financials holdings. Within the Health Care sector, our biggest winner was Tripath, which was up 31% after being bid for by Becton Dickinson at an 85% premium. Tripath represents the 11th company in the portfolio taken over this year, which we believe is confirming evidence that our process identifies attractive, undervalued businesses. The only bad part about having our undervalued companies taken over is that we must find new ideas in which to invest. This has not been so easy as of late. However, we still find winners and are encouraged by several of our fairly recent Health Care additions to the portfolio such as Allscripts (+28%), FoxHollow (+17%) and CNS Inc. (+16%). Our Materials holdings were led by core positions in Agrium (+17%), Methanex (+14%) and Lubrizol (+15%). Our higher quality positions also led the way among our Consumer holdings with Men's Wearhouse (+22%), Wolverine World Wide (+21%), and Oxford (+11%), complemented by relatively new buys, Strayer Education (+11%) and Yankee Candle (+17%). Yankee Candle received a bid from a private equity group this quarter.

Current Investment Environment: “Risk and return are all out of whack”

We are in uncharted waters because of the dramatic explosion of structured products and tools, which help investors “manage risk.” We believe massive growth in derivative structures, combined with risk management tools, may be leading to a misallocation of capital and temporary breakdowns in market efficiency. Why?

1) Growth in derivative structures has exploded over the last 3 years. To hedge interest rate and currency risk, the interest rate and currency derivatives markets have grown to \$200 trillion (16 times U.S. GDP). To hedge corporate bond default risk, the Credit Default Swaps market has grown to \$17 trillion from almost \$0 five years ago. Today, General Motors has approximately \$30 billion in debt, but \$200 billion of Credit Default Swaps trade to insure against \$30 billion of potential default. How is that for irony? The market created to insure against risk has actually increased risk by 6.67 times! To hedge against size risk, the proliferation of structured product and ETFs make shorting the Russell 2000 Index easier. To short the Russell 2000 Index it used to cost Libor +100 basis points. but it now costs Libor -100 basis points. Today, \$1.1 trillion of structured product is benchmarked to the Russell 2000 Index, but the available float is only \$1.3 trillion.

2) Wide-spread adoption of “better” risk management tools encourages investors to utilize derivative structures to take on more risk in order to reach for more return. Tools, like the Black Litterman Mean Variance Optimization model, are encouraging investors to allocate away from large liquid asset classes, like bonds and large cap stocks, to “higher return, uncorrelated,” but less liquid asset classes like commodities, timberland, private equity, hedge funds, small caps and micro caps. Derivative structures are used to implement these strategies because they are more liquid than the underlying assets being traded. For example, it is easier to buy \$1 billion worth of a commodity Exchange Traded Fund than it is to buy, transport and store \$1 billion worth of gold, silver, titanium, oil and sugar.

3) The consequence of wide-spread adoption of risk management tools that utilize derivative and structured product to manage risk is that risk seems to have disappeared from the system. Risk is no longer visible through our traditional lenses like yield curve, credit spread and small cap risk premiums, to name a few. Inflation risk, which the Federal Reserve is still concerned about, used to be reflected in the long end of the yield curve, but that can be hedged away resulting in a flat yield curve. Default risk, which used to be seen by comparing low-quality versus high-quality yields, is nonexistent because growth in the Credit Default Swap market spreads the risk throughout the system, resulting in low-quality corporate bonds trading similarly to high-quality corporate bonds. Liquidity risk associated with small companies, which we used to see by observing a size-based discount rate differential, has turned negative perhaps because of the dramatic growth in structured product and ETFs benchmarked to the Russell 2000 Index.

The question that Mr. Tanzi poses, “Do we really understand what is going on in the derivatives market, a market that in 2005 was 22 times the U.S. gross domestic product?” is an important one. Many stewards of our financial system believe they know the answer and believe growth in the derivatives market has made the financial system more stable and less

risky because it spreads risk to more players, lowering the chances of a major financial institution going bust and causing a financial crisis. If those stewards are correct, they may have explained why the size differential need not revert to its historical average. However, think about that for a moment. Risk, like matter, can not be created nor destroyed. It simply changes form. In the current environment, risk has changed form from something we can easily see to something that is harder to see, but we know it is still out there. If risk is out there, who is holding it? Alan Greenspan says it is not the banks, so one might surmise it is the investors who have allocated more capital to “uncorrelated higher return,” but illiquid assets. The fallacy of the risk management and allocation models that investors are using to manage risk and return is that they conveniently ignore a lot of things, including liquidity. This seems like a false alarm until it is time to sell.

Amaranth, the formerly \$9 billion hedge fund who lost \$6 billion in one week, utilized the best risk management tools money could buy but learned a tough lesson that others should heed. When you have to sell a lot of an illiquid asset, the risk tools have no way of incorporating the price impact. It is ironic that, as Amaranth was melting down, Bill Sharpe, the pioneer of risk management tools that derivative markets are built on, came out with a new book “Investors and Markets: Portfolio Choices, Asset Prices and Investment Advice.” Mr. Sharpe is rethinking risk and now believes risk models need to better incorporate the notion of extraordinary economic events, taxes, price impact and liquidity. We agree!

We must seem old fashioned by warning about how new innovative models and tools could lead to market instability, but history is on our side. Consider other Wall Street innovations like “portfolio insurance,” “junk bonds” and the “QQQs,” which ultimately became crowded trades and imploded due to liquidity issues when the hot money all wanted out at the same time. We believe in the old-fashioned truth that the value of any investment is the present value of the expected net cash receipts. Price is a function of future net cash receipts and a discount rate. We monitor CFROI and growth to better understand future net cash receipts, and we monitor the discount rate to observe risk. In 1999, the +300 basis point size differential told us that the market was paying too much for risk and, therefore, we were aggressive in small cap companies. For the last few years, the -100 basis point differential tells us the market is not paying for risk. Therefore, we are a little more defensive today.

It is possible that the world and small caps are less risky today, and if that is true, our portfolio should chug right along, putting up pretty good investment returns. As much as we would like to believe that the world is less risky, we suspect that the -67 basis point size differential is partially a result of the hyper growth in structured product benchmarked to the Russell 2000. If true, we should expect the return of the small cap risk premium, as growth in structured product benchmarked to the Russell 2000 Index slows or reverses. We also suspect that this quarter’s strong performance of large liquid investment classes, like large cap value and treasury bonds, could be a result of smart money recognizing the risks of increasing exposure to less liquid markets identified in this section.

Strategy:

Our strategy never really changes. We buy companies that are doing the right thing to create shareholder value and have a high probability of beating expectations implied by their share price. To that end, we feel great about our stock selection process. Eleven of our holdings have been bid for this year, which we believe, along with our solid hit rate on new buys, validates our stock selection process.

However, there are a few things we can do to position the portfolio a little more defensively. First, we can tilt the portfolio away from the “crowded trade” by owning small companies not necessarily included in the Russell 2000 Index. Second, we can own relatively more “corks,” which are typically safer companies with lower volatility. Third, we can own more high quality “golden goodies.” In all cases, we remain true to our disciplined investment process, which should help us power through any size differential adjustment and take advantage of liquidity-driven valuation opportunities.

Since risk premiums seem to be subtly resurfacing, but have a long way to go before returning to “normal,” we believe a more defensive position remains prudent. Therefore, the portfolio is overweight the relatively less risky Corks and Golden Goodies, which embeds a modest quality tilt in the portfolio. We are also running at a slightly higher level of cash as we wait patiently for opportunistic entry points for companies we want to own.

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.