



October 2007

***IronBridge Capital Management, L.P.  
Third Quarter 2007 Small Cap Core Review***

**“It is better to have lent and lost, than to have never lent at all.”**  
Anonymous Mortgage Broker, August 2007

Dear Fellow Investor,

So much for the summer doldrums! After falling as much as 14% intra quarter, the Russell 2000<sup>®</sup> Index recovered, falling only -3.09% for the third quarter. We are pleased that our Small Cap Core product increased roughly 3%<sup>1</sup>, significantly outperforming our benchmark. Year-to-date, the strategy has outperformed its benchmark by approximately 1200 basis points, advancing nearly 16%.

Excess return is simply a result of finding winners, while avoiding losers. This year has been an extraordinary year (meaning – do not expect this kind of outperformance every year), where our disciplined investment process has resulted in more than our fair share of winners and avoiding more than our fair share of losers. In the first two quarters, many of our stocks were bid for at significant premiums when merger activity spiked due to easy credit. Acquirers were attracted to our companies due to their high cash flow, low leverage and attractive valuation characteristics. This quarter, the subprime meltdown hit mortgage lenders and housing-related stocks particularly hard with several bankruptcies. Thus, their share prices fell significantly. Our valuation work indicated too much downside risk existed for companies exposed to the housing bubble, so our portfolio had very little direct exposure. Fortunately, we avoided a lot of the carnage that dragged down the performance of the Russell 2000 Index.

**Third Quarter Performance Attribution:**

Our Small Cap Core strategy outperformed the Russell 2000 Index by approximately 600 basis points, which is at the higher end of what we would expect from any given quarter. In fact, it is statistically significant and should happen only once in twenty quarters. As should

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<sup>®</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>1</sup> Past performance does not guarantee future results. Returns reflect reinvestment of dividends, gains, and other earnings.

be the case, stock selection contributed nearly all of the excess return while sector allocation contributed at the margin.

Stock selection was particularly strong among the Industrials, Consumer Discretionary, Energy, Information Technology, Financials, and Health Care sectors. Winners were concentrated among our Rockets. Several Rockets “took off” this quarter despite the market turmoil. For example, Cepheid (+56.3%) is gaining broad adoption of their GeneXpert platform which utilizes biomarkers to more quickly and accurately identify disease or dangerous agents. FMC Technologies (+45.6%) had a blow out third quarter as they continue to gain market share at major oil drilling sites where their technology significantly increases the yield when oil is particularly difficult to extract. Generally, most of our companies are hitting their milestones laid out in our investment thesis and are moving toward our target prices.

The quarter was not perfect. We had a few stinkers, like PFF Bancorp (-44.5%), whose fundamentals continued to deteriorate in a flat yield curve and deteriorating credit environment. We expect a few troublemakers every quarter as our process only requires us to be right 50% of the time and maintain ownership of companies with twice the upside potential compared to downside risk.

The sector allocation’s modest contribution to relative performance was derived mostly from being underweight 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.

### **August: Revenge of the Sand Pile**

Several clients asked us to report on how the portfolio did during the panic sell-off in August. The answer is “just fine.” We hate to say it, but if you read through our past shareholder letters, they highlight our concern that certain areas of the market were not pricing risk properly and that investors were valuing diversification of return over net cash receipts, which is dangerous. Over the long run, the value of any financial investment must equal the present value of its future net cash receipts. Diversification works when few people engage in it as they find diversification of net cash receipts. However, when more people try to diversify into similar less liquid asset classes at the same time, uncorrelated price action becomes correlated as changes in price reflect changes in the discount rate rather than changes in forecasted net cash receipts. When too much capital enters illiquid asset classes, discount rates drop to accommodate the inflows. This liquidity-induced distortion contributed to the disappearance of normally observed “risk premiums.” We did not know when investors would recognize this, but we were confident that eventually the market would remind them. The reminder that risk exists, even when you can not see it, came in the form of the subprime loan meltdown.

The amazing act of the disappearing risk premium (now you see it, now you don’t) was performed by Wall Street investment bankers cloaked in a cape of “financial innovation.” These magicians performed an impressive trick that sucked in an unsuspecting audience

(mostly foreign banks and hedge funds) who were dazzled by the higher returns with less risk. They performed their magic by the clever slicing, dicing, packaging, distributing and selling of mortgage and other debt. What is truly amazing is how many smart people believed the fantasy. The illusion was exposed when investors discovered the hard way that there was a flawed assumption in their risk models. The faulty assumption was that future default rates would be similar to past default rates. What the financial magicians failed to comprehend was that the distributed risk theories, which mathematically proved they could lower risk to investors while attaining a higher return, actually changed the structure of lending from a principal model (lenders holding the debt to maturity) to an agency model (originating and immediately selling debt into structured debt products). The situation illuminates a classic flaw of quantitative models and illustrates why “three standard deviation events,” which **theoretically** occur only once in every 740 years, occur much more frequently in the **real world** – more like once every few years. The August meltdown followed the lessons of the sand pile game. In case you forgot, here is a quick refresher.

#### Lessons of the Sand Pile Game:

- Reprinted from our First Quarter 2007 Small Cap Core Review, April 2007 -  
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.”

Still don't get the connection? Let me help, “*history never repeats, thereby making the future unpredictable.*” In order for the magicians to pull off their trick, they needed future default rates to approximate historical default rates. They needed history to repeat. Why doesn't history repeat? Because...

“*History can never be washed away. It affects the future of dynamic systems.*” The advent of innovative structured debt products that slice and dice “risk” in new ways changed the structure of lending from a principle model (lenders holding the debt to maturity) to an agency model (originating and immediately selling debt into structured product). Since agents do not need to worry about getting their principle back, the loan quality deteriorated, thereby guaranteeing higher future default rates than past default rates. The risk models, which are based on backward-looking history, could not incorporate the concept that “history never repeats” and did not foresee higher future default rates, which are predicted by those willing to use common sense or forward-looking net cash receipt models. Therefore, higher than “modeled” default rates undermined the higher returns promised.

“*As the grains collect, they organize into a unique critical state riddled with ‘fingers of instability’ of all possible lengths and sizes.*” A housing bubble expanded (one grain), systematic leverage increased (another grain), loan quality deteriorated (another grain, plus

thousands more). *“Tension grows. Eventually, one of these fingers of instability slips and gives way.”* Loan default rates rose above expectations, and hedge funds that were invested in these structured debt products started to lose money, which was exacerbated by leverage (in some cases, ten times leverage). Hedge funds were allowed to value these structured debt products at “model” because they were traded so infrequently. However, when they needed to sell, the hedge funds had to mark to market, which was a significantly lower market price than their theoretical models. Given that the real world prices of the structured debt they owned was significantly lower than their theoretical models, they found themselves much more highly leveraged than they had thought. Several hedge funds went bankrupt (Bear Stearns, UBS). Even the gold standard of hedge funds, Goldman Sach’s Global Alpha fell 16% and required an emergency capital infusion to stay afloat.

*“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.”*

Quantitative funds (those that use computers to buy and sell stocks) got crushed because the risk models of diversification, based on modern portfolio theory and mean variance optimization, failed as historically uncorrelated assets became correlated. Backward-looking statistical models could not see it. Whereas, forward-looking models based on future net cash receipts could see that discount rates are converging and, therefore, historical correlations may break down in the future. Meanwhile, the quant managers explained to their clients in “quant speak” that huge losses were a three standard deviation event, meaning that their models insist such losses should only occur once in 740 years. Credit markets seized. Hedge funds were sellers, not buyers, of everything. Investment banks, thinking they were agents (originate and sell the loan), became principle lenders again as they got stuck with \$200 billion worth of debt to finance acquisition funding commitments. Deals started to fall apart like Harman, Acxiom, and others. The fingers of instability even extended to Northern Rock, a bank domiciled in the United Kingdom, where there was an old-fashioned bank run resulting in a line of people as far as the eye could see trying to withdraw their money. Students expecting college loans were unable to receive them because their main source of credit was from a German bank that experienced huge losses on subprime assets. And the complex network of fingers of instability goes on and on... The great unwinding of leverage seemed underway.

At the same time, we were finally identifying great entry points for stocks that we have wanted to own, but were too expensive earlier in the year. We bought a lot of new stocks this quarter and added to several during the market decline in August. We are embarrassed to admit experiencing a little bit of Schadenfreude (German word for pleasure from others pain) because we viewed the market meltdown as a correction – the capital markets took capital away from those that do not deserve it. The market was taking capital away from the parasites on the financial system and those that were not acting as good stewards of capital. This is actually a good thing for the long-term health of the market. Real problems occur when governments interfere with the natural market clearing process.

Then, what we have termed the Hedge Fund Relief Act of 2007 occurred. Mr. Ben Bernake saved the day by first lowering the federal funds rate and, later, by lowering the Federal Reserve discount rate by 50 basis points. The credit crunch and potential financial crisis was

averted. We now ask ourselves, “Is that it? It only took a two week 14% correction to clear out all the parasites and poor stewards of capital?” That wasn’t so bad. Or maybe the market clearing process has further to go, but the Fed’s action increases the chances of a more orderly clearing process. We just do not know. Stay tuned.

## **Outlook**

Our outlook is a little more cautious given recent events. Stock picking will be even more important since it appears the “free ride” on the discount rate might be coming to an end.

We wonder, what does Mr. Bernanke see that motivated him to lower the discount rate by 50 basis points? Could it be a higher probability of recession and/or a disorderly deleveraging of the financial system? His actions must be viewed as pre-emptive. Meanwhile, we are about to get a lot more data points as corporate earnings season kicks off at the end of October. Last quarter we felt generally bullish because “forces remain in place and include plenty of global liquidity, increased private equity activity, robust corporate profits, and reasonable growth driven by globalization.” Mr. Bernanke seems to have averted a liquidity crisis, but even orderly deleveraging would clearly reduce liquidity. Or, does the 50 basis point decrease encourage re-leveraging? Private equity deals, like Harman and Acxiom, are falling apart right and left and are likely to subside until the debt overhang can be absorbed and the credit markets improve. However, the credit markets will never be as lax as they were for the last couple of years because investors have been reminded that risk exists even when you can not see it. Investors are now more aware of the dangers associated with the shift from a principle model to an agency model lending structure. As for corporate profits, they seem robust among industrials, materials and technology, but profits are clearly evaporating among consumer and financial sectors.

Finally, the forces of globalization appear to be in tact, but the dark side of globalization peeked its head out when foreign bank losses from U.S. subprime loans at a German bank impacted capital available for student loans in the U.S. We are in uncharted territory – so much so that the governor of the Bank of England admitted, “We don’t understand the markets.” A little scary, but we are comforted that we have an economic framework rooted in sound financial principles of long-term wealth creation and a unique life cycle-based risk control process to guide us through whatever comes next.

Thank you for your continued support.

Kind regards,

A handwritten signature in black ink, appearing to read "Christopher C. Faber". The signature is fluid and cursive, with a large initial "C" and "F".

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