



January 2007

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

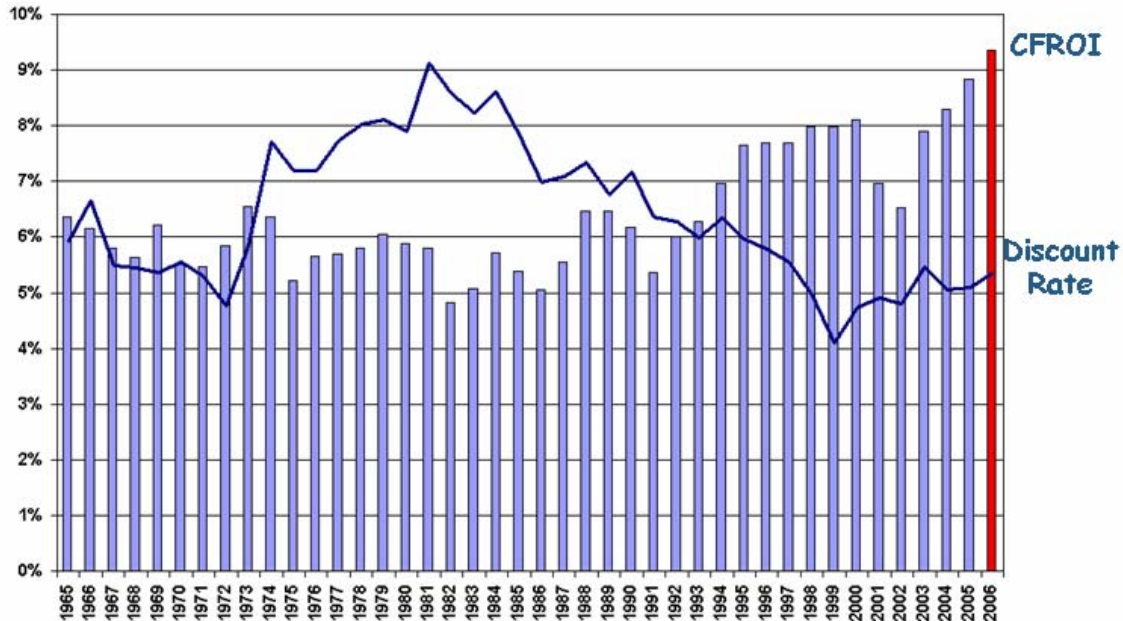
Dear Fellow Investor,

The year 2006 was great for stocks. For small stocks, the year was defined by volatility and rapid changes in sector and Life Cycle leadership, an increase in M&A activity, lower quality outperforming higher quality, value outperforming growth and a disregard for most kinds of risk, especially liquidity.

For the year, the small cap core product appreciated by approximately 15%. The Russell 2000[®] Index, which was up 18.37%, proved especially difficult to beat due to unusual trading during its annual rebalancing in July. The reconstitution, along with the significant proliferation of structured products benchmarked to the Russell 2000[®] Index, such as Exchange-Traded Funds (ETFs), resulted in phantom excess performance of the index relative to other small cap benchmarks and the small cap universe in general. By comparison, the S&P SmallCap 600 Index was up 15.12% and small companies (<\$2.5B in market cap) outside the Russell 2000[®] Index were up 14.66%.

Despite trailing the Russell 2000 benchmark, we feel our performance relative to the small cap universe and the average small cap manager was okay, but not great. According to Morningstar, the average small cap core mutual fund was up 14.6%, the average growth fund was up 12.0%, and the average value fund was up 16.9%.

Valuations were lifted by record-breaking levels of CFROI^{®*}, which were higher than expected, and a low, but curiously rising, investors' discount rate.



Source: Credit Suisse HOLT

Since 1965, CFROI has averaged about 6.2% within a range of about 5-7%. However, one can not help but notice that a breakout to new highs seems to have occurred since the mid 1990s with a new range of between 6-9%. A more recent 10-year average seems closer to 8%. This raises a few very important questions: Why is this happening? How sustainable is it? More on this later...

Fourth Quarter Attribution:

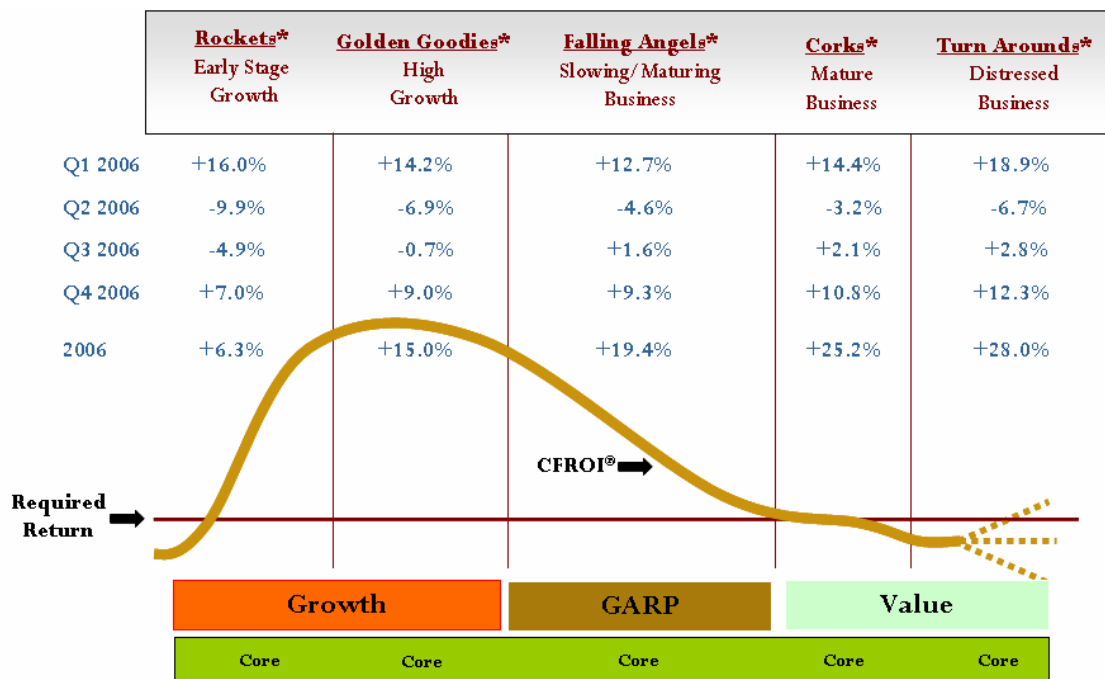
The small cap core product's return for the fourth quarter approximated that of the Russell 2000[®] Index, which was up 8.90%. Generally, the portfolio was more cautiously positioned, running with slightly higher-than-normal cash levels, underweight Rockets and Turn Arounds (higher risk/lower quality) and overweight Corks and Golden Goodies (lower risk/higher quality). Positive stock selection was essentially offset by a negative contribution from sector allocation and cash drag. Stock selection was particularly strong among the Energy, Materials, Industrials, and Technology sectors and weaker in Health Care and Consumer Discretionary.

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

Full Year Attribution:

For the full year, stock selection detracted nearly 125 basis points relative to the Russell 2000® Index, while sector allocation detracted only modestly, and cash drag subtracted nearly 100 basis points. Stock selection was strong among our Energy, Materials and Financial holdings but weaker among our Consumer Discretionary, Staples and Industrial holdings. By Life Cycle, stock selection was very strong among the Rockets and Falling Angels, but weaker among the Corks and Turn Arounds. Several lower-quality Turn Arounds on the verge of bankruptcy did very well this year. We believe this is due to easy access to capital and investors' disregard for credit risk. As a consequence, our higher-quality Turn Arounds simply lagged. We were surprised by the underperformance of our Corks, but much of the Cork performance came from commodity-based businesses and the unexpected strength of Utilities, as well as alternative energy plays, such as corn, among the Consumer Staples. It is very unusual for Utilities and Consumer Staples to lead a robust market, but that was the kind of year 2006 was, and it illustrated why industry and Life Cycle diversification are so important.

The chart below depicts returns by Life Cycle for the Russell 2000® Index. As you can see, performance by Life Cycle class was volatile in 2006, which reinforces the benefit of Life Cycle diversification as a tool for managing risk.



A final comment regarding stock selection relates to the unusually high number of takeovers we experienced in the portfolio this year. In fact, eleven of our companies were bid for by financial or strategic buyers, which equates to approximately 10% of the portfolio! Four stocks held in the portfolio remain rumored targets at year end. We believe this confirms our investment process is good at identifying undervalued businesses. That is the good news. The bad news is that takeovers force sales and higher turnover, which forces us to find new

buys. We have to confess, finding new buys has been more difficult based on current market expectations for CFROI and growth among our small cap universe. As a result, our cash levels were a little higher than preferred (at the upper end of our 0-5% range) amidst the market's strong advance.

Why is corporate profitability so high? How sustainable is it?

“Corporate profitability is at an all-time high. The investors’ discount rate for small companies is near 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% of our stocks disappointed, and those that disappointed did so only modestly... The environment for wealth creation has never been better.”

We wrote the above quote last year and it is still true this year and may even be true again next year. Indeed, we have observed rising, above-average CFROIs for several years now. That trend seems to defy the economic law that, over the long term, CFROIs should approximate the investors’ cost of capital. In past commentaries, we have written about several possible explanations for the sustained and widening spread including:

- 1) Capitalism’s triumph over Communism
- 2) Spread of freedom and capitalism around the world
- 3) The U.S. seems to be the main beneficiary of globalization and free trade
- 4) A productivity boom based on the technology and internet revolution
- 5) The birth of the Platform Company
- 6) Understated inflation statistics by the U.S. government due to changes in measurement

We think the answer to why real profitability is so high is “all of the above.” This year, we will add one more explanation, which is inferred by the preceding ones.

- 7) In the interest of self preservation, the Chinese government is engaged in a “Jobs for Profits Trade” with the United States by pegging its currency to the U.S. dollar.

China and the U.S.: Jobs for Profits Trade

China has over one billion people and only a small percentage are participating in China’s capitalist boom. Most are still mired in the agricultural economy. In order to maintain social stability, the Chinese government needs to bring these agricultural-based workers into the industrial age by exploiting a labor arbitrage that exists between the U.S. and Chinese workers. The need for social stability is so great that often Chinese companies will produce goods and sell them in the global marketplace below cost in order to create more jobs. We believe this is why Chinese banks have an incredibly high level of nonperforming loans, which is a condition that would be unacceptable in a genuine capitalist economy. Inference: Chinese businesses earn returns significantly below their cost of capital.

Managers of U.S. companies, who care about profits and earning returns above their cost of capital, exploit China’s willingness to forgo economic profits, which is resulting in ever

higher CFROIs for U.S. companies. Without the Chinese peg to the dollar, labor rates and prices would adjust in dollar terms via freely floating exchange rates. However, the peg stifles this market mechanism, deferring the economic law, which should drive CFROIs towards the cost of capital. It would not surprise me if the weighted average CFROI of China and the U.S. turns out to be around 6.2% with China at 0% and the U.S. at 10%! How can China continue to grow with 0% returns? Answer: Print money, which adds even more liquidity to the global financial system and limits both the Federal Reserve's relevance and its ability to manage liquidity.

The consequence of this trade appears to be an ever-widening trade deficit, ever-increasing U.S. profits, ever-increasing levels of liquidity, and ever-rising markets. Under normal circumstances, freely floating exchange rates would ultimately reduce the labor arbitrage and contain deficits, liquidity and the prices of financial assets. However, the Chinese peg to the U.S. dollar inhibits this.

The Ripple Effect on Financial Markets

China needs a large, safe, liquid place to put all its dollars and the largest, safest, most liquid market in the world is the U.S. Treasury Bond market. So China buys U.S. debt, causing artificially low interest rates, which results in a flat to inverted yield curve. This sets off a sequence of events where pension boards realize that the present value of their future obligations has just increased significantly (due to higher present values of future obligations derived from lower rates), and boards realize that the expected return of their portfolio is not enough to meet future obligations. Pension fund boards begin to seek advice from Nobel laureates as to how to increase the expected return from their portfolio without increasing risk (the "cake and eat it too" request). The solution to the "cake and eat it too" request is diversification. The implementation tool is the Mean Variance Optimization model, which values diversification over expected net cash receipts and relies on historical returns to forecast future returns. The tool prefers any asset class that has a decent long-term investment return but is not correlated to the S&P 500 Index or the corporate bond market. Most of the asset classes the model prefers are illiquid, such as emerging markets, small caps, commodities, private equity, REITs and hedge funds. Simultaneously, the Pension Reform Act encourages boards to diversify using academically sound tools, such as mean-variance optimization.

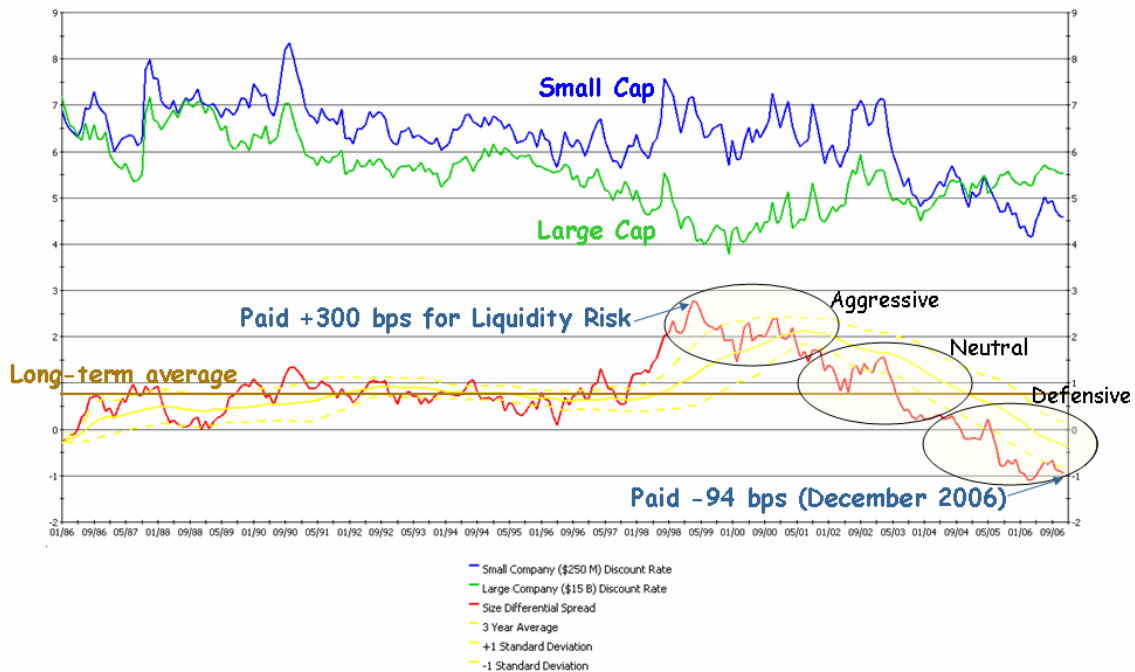
According to Henry McVey at Morgan Stanley, asset classes are becoming more correlated over time. This begs the question, "How do mean variance optimization models cope when acting on the output causes markets that were uncorrelated in the past become correlated in the present?" Someone will ask and answer that question in the future when boards ask, "What went wrong?"

For now, pension funds, foundations and individuals move en masse to reallocate from large liquid investment classes like large cap stocks and bonds into illiquid asset classes like small caps, private equity, commodities, REITs and hedge funds which also participate in illiquid markets. But illiquid markets are not so easy to invest in, so Wall Street innovates by expanding the futures markets, the derivatives market and creating multiple ETFs (exchange traded funds) to create the illusion of liquidity where little exists. We believe the effect of

massive adoption of these mean-variance optimization models has contributed to the price spikes associated with various illiquid markets like commodities, baskets of stocks tied to ETFs, energy contango in the futures markets, the REITs, and, yes, the 18.37% return from Russell 2000 this year.

Of particular interest to us is the boom in ETFs benchmarked to the Russell 2000, which we believe has created a breakdown in market efficiency, mass underperformance by active managers and might explain why out-of-index small companies underperformed in-index companies by 400 basis points this year. We have not observed mass underperformance like this since 1999, which is when large cap managers failed to keep up with the S&P 500 due to the growth in popularity of S&P 500 Index funds. The underperformance did not last long. We would like to take 100% credit for the generous absolute return of the product this year, but it appears a good part of it could be liquidity driven.

The magnitude of the liquidity impact on the market can be seen by observing Credit Suisse HOLT's large and small cap liquidity risk premium discount rate differential. A negative 100 basis points is about as low as it has ever been, which means that investors are paying 100 basis points to take on liquidity risk.



Source: Credit Suisse HOLT ValueSearch (Data Date: January 5, 2007)

How sustainable are liquidity-driven markets? So far, a lot more sustainable than we would have imagined. All we can say is that the last time discount rate differentials were this “out of whack” was during the mega-cap and tech bubble in 1999. Therefore, the above data supports our somewhat more defensive portfolio structure. Indeed, our portfolio outperformed 70% of the down days for the year, given our higher quality, lower risk tilt.

Strategy for 2007:

Stock market volatility will likely continue in 2007 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. We welcome all this change, because fundamental investors like us have a disciplined framework that can cope well and can look forward to money-making opportunities as the imbalances unwind. Meanwhile, we stick to our wealth-creating strategies.

Investors will continue to try to sort out whether the economy is headed for a soft or hard landing. They will monitor the housing, sub prime 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 that might mean for investor taxes, 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 will cause volatility 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 at attractive entry points.

Our disciplined Life Cycle and industry diversification should help us weather the expected volatility by neutralizing factor bets and allowing performance to be driven by stock selection.

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.