



January 2008

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

Dear Fellow Investor,

We are very pleased to report that our Small Cap Core product increased over 10%¹ compared to -1.57% for the Russell 2000^{®2} Index in 2007. By staying true to our disciplined investment approach, we were able to prosper in a challenging investment environment. During the year, the Small Cap Core product significantly outperformed our performance benchmark in three out of four quarters as good, fundamental bottoms-up stock picking dominated the performance profile. Mostly, we are happy for our clients who maintained their confidence in our skill and were rewarded so handsomely this year for their patience.

The significant excess return achieved this year had been building over several years as the market-distorting influences, identified in last year's commentary, started to unwind this year. As a reminder, last year, we were concerned that globalization and financial "innovation" was driving excess liquidity, which was responsible for creating market distortions, potentially resulting in a broad misallocation of capital and a dangerous mispricing of risk. The result was leadership among lower quality, higher risk, overvalued, less liquid companies, which we refused to own due to our disciplined framework. We (and many other active managers) looked pretty foolish in 2006 when compared to our Russell 2000 benchmark. This year, the subprime crisis exposed the illusion of the disappearing risk premium. Risk has started to be priced more rationally, which has significantly benefited the IronBridge portfolio relative to our benchmark.

The unwinding of financial "SINnovation" may be signaling a turning point in market leadership. In 2007, large capitalization stocks outperformed small capitalization stocks for the first time in eight years. Growth outperformed value for the second time since 1999 (the last time was 2003). Active portfolio managers outperformed ETFs and other passive strategies. Quantitative strategies performed poorly as their backward-looking models typically failed to capture inflection points. Uncorrelated asset classes became correlated

¹ Return is gross of fees. Past performance does not guarantee future results. Returns reflect reinvestment of dividends, gains, and other earnings.

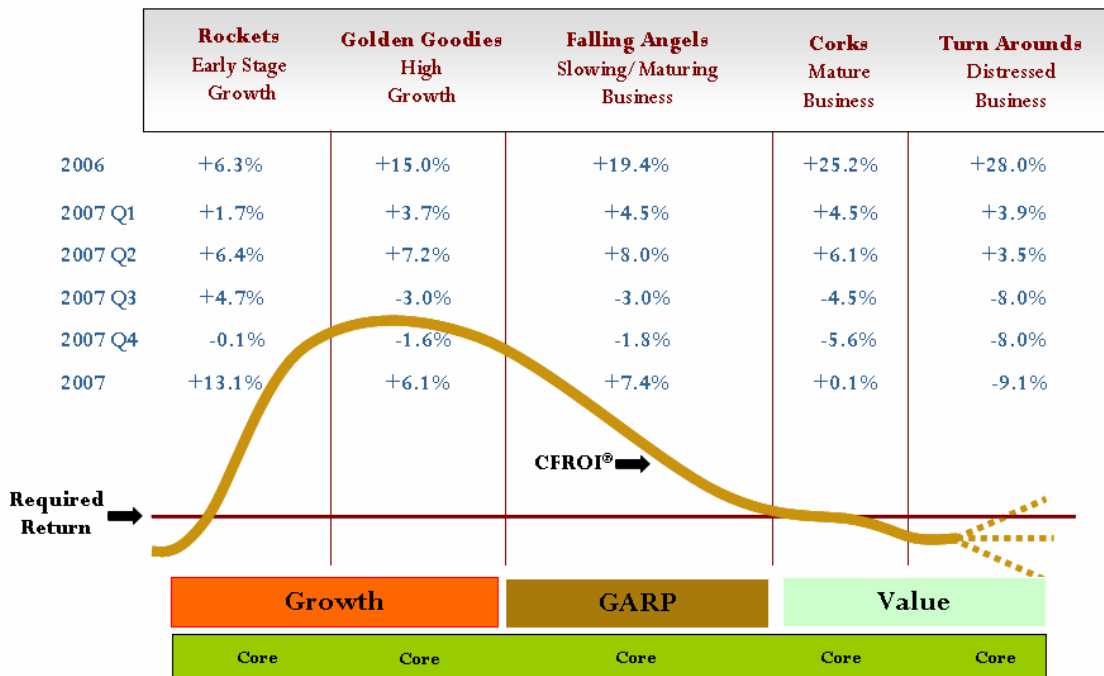
² Russell 2000[®] Index is either a registered trademark or tradename of Russell Investment Group in the U.S. and/or other countries. Indexes are unmanaged and cannot be invested in directly.

during market meltdowns. All of these observations are potentially related to the unwinding of financial sinnovation. The big question facing the markets over the next few years is whether the “great unwind” will occur in an orderly fashion or whether the government will re-flate the financial system in order to stave off a potential financial crisis.

Fourth Quarter Performance Attribution

During the final quarter of 2007, the performance of the Small Cap Core product approximated the -4.58% return for the Russell 2000 Index. Stock selection was particularly strong among our Information Technology, Financials and Health Care names but weaker among our Energy, Consumer Staples, Materials and Industrials holdings. The sector allocation’s modest contribution to relative performance was derived mostly from nearly 5% cash.

The chart below depicts returns by Life Cycle for the Russell 2000 Index. Growth significantly outperformed Value for the quarter as well as the whole of 2007, which is a reversal of what happened in 2006. Rockets outperformed the Turn Arounds by 2,200 basis points.



Source: IronBridge Capital Management, L.P.

We can never predict which style will be in vogue from one year to the next, which is why Life Cycle diversification is so critical to our strategy of consistently outperforming the market. We will always maintain Life Cycle diversification as part of our portfolio risk controls. However, we cannot help but to hypothesize why Growth outperformed Value this year and ponder whether 2007’s trend may be sustainable?

Could Growth outperform Value again next year? Maybe... we can think of five potential reasons.

- 1) Tax changes – Literally none of the presidential candidates are discussing extending the Bush tax cuts on dividends and capital gains, despite the fact that they led to record government revenues. If the tax cuts expire, the tax on dividends will increase from 15% to 35%, making dividend-paying stocks (value stocks) much less attractive relative to non dividend-paying stocks (growth stocks), where the tax will increase from 15% to 20% for long-term gains.
- 2) Many value stocks have been the beneficiary of financial innovation, which may have culminated in the “illusion of Wealth Creation” as a result of the disappearing risk premium.
- 3) Value stocks may have benefitted from private equity engaging in legitimate wealth transfer strategies, which have accelerated over the last several years due to excess liquidity, but may now be unwinding due to the current credit crisis.
- 4) Most wealth creation occurs on the left side of the Life Cycle, where innovation drives excess return, growth and shareholder value. As Rockets and Golden Goodies innovate to meet the world’s needs such as alternative energy, a more efficient electricity grid, as well as better and more efficient delivery of health care, growth may be relatively less affected by the subprime and housing meltdown currently under way.
- 5) Innovation is likely to continue regardless of credit creation because there is still plenty of global capital available to fund great life-improving ideas.

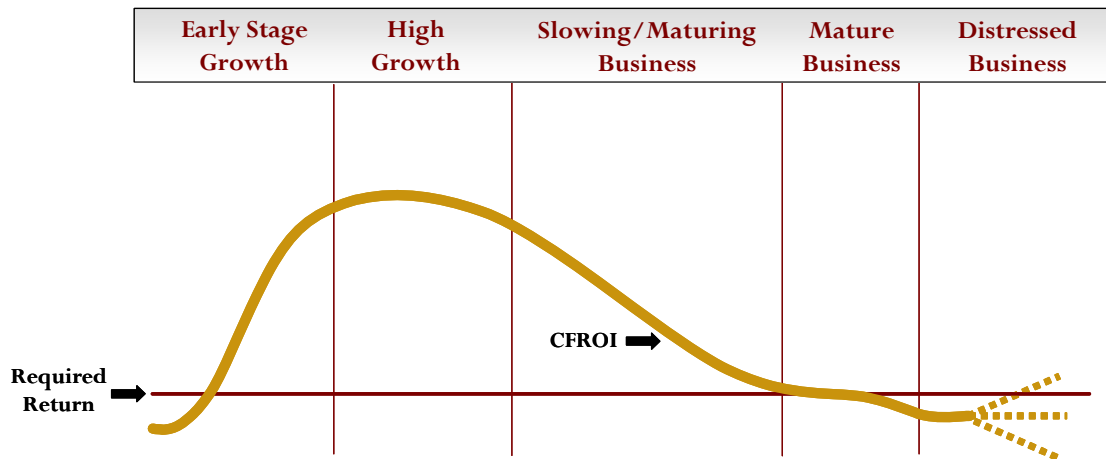
Wealth Creation/Wealth Transfer and the Beauty of Financial Crisis

Wealth Creation occurs through innovation. The innovator creates, or more efficiently produces, a product, good or service that people need or want to improve their lives in some way. In exchange for the product, good or service that improves peoples’ lives, the innovator earns an economic return above the cost of capital and grows until the world has as much of the product, good or service that it needs or until another innovator/competitor delivers the product, good or service more efficiently, at which point the excess economic return that the innovator had earned falls toward the cost of capital.

Legitimate *Wealth Transfer* occurs when there is an exchange of products, goods or services at an agreed value between two willing parties whereby both parties operate with trust and integrity without intent to mislead or defraud. Markets exist to facilitate legitimate transfer of wealth between millions of different economic participants with millions of different needs, which enables the most productive use of the economy’s resources benefitting the whole of society.

Wealth creation is the byproduct of innovation. Wealth transfer is the lubricant that allows capital to flow to its most productive uses. This is the magic of Adam Smith’s “invisible hand” and why Capitalism is history’s most successful economic framework for meeting the needs of society as measured in lifespan and quality of life.

In the competition for capital, the winners and losers are constantly shifting as wealth creation and wealth transfer interact to allocate the economy's resources to their most productive uses. This is the nature of the corporate Life Cycle, which is at the core of the IronBridge investment process.



Source: IronBridge Capital Management, L.P.

To maximize the benefits of a capitalist system, ALL parties must act with integrity, otherwise, *illegitimate wealth transfer* occurs, which is extremely harmful to the system because it results in a misallocation of capital and always leads to financial crisis.

Illegitimate wealth transfer occurs when one party intentionally misrepresents value in an exchange with the intent to gain wealth without creating wealth. Fortunately, most wealth transfers are legitimate because most agents are good and act with trust and integrity and have of rule of law and property rights to protect them against bad agents.

Occasionally, participants confuse wealth creation with wealth transfer in ways that create the *Illusion of Wealth Creation*. One very common example of the illusion of wealth creation is share buybacks. Often, companies tout their commitment to shareholder wealth creation by “buying back shares,” which is funny because, in most cases, share buybacks are wealth transfers. Cash (owned by shareholders) is transferred back to selling shareholders through the company’s purchase of their shares in the stock market. The offset is that non-selling shareholders own more of the firm. However, managers that focus on (and who are compensated based on) growth of earnings per share love to see earnings per share increase by lowering the number of shares outstanding. Growth of earnings per share creates the illusion of wealth creation. Whereas, in reality, buybacks are a wealth transfer strategy and, assuming equal tax rates on dividends and capital gains, are equivalent to a dividend. The illusion will not really harm anyone in a material way. Perhaps, the CEO gets over-paid for EPS growth that created no value, or perhaps an investor expecting to get an excess return only gets an average return, but there is really no harm in this example. The harm occurs when the illusion creates overconfidence, resulting in the willingness to take on unsustainable debt levels.

Debt is a wonderful thing when it is used to fund true wealth creation. For example, many private equity firms utilize debt to take control of businesses performing well below their long-term potential. Then, private equity managers, by applying innovation, make those businesses more productive and more efficient and, therefore, more profitable. In short, they create value through better capital allocation and more efficient production, and the value they create is used to pay down the debt. The wealth created in excess of the debt taken on is paid to the investors of the fund (and there is a little left over for the managing partners). Private equity may even prove to be the savior of the U.S. auto industry. However, debt can destroy a company if it is used to fund financial engineering, resulting in the illusion of wealth creation, and not used to fund actual wealth creation.

In our share buyback example, if the company uses debt to buy back shares and does not do anything more efficiently to run their business, they are using debt to fund a wealth transfer strategy rather than a wealth creation strategy. They are creating no wealth. They might think they are executing a cost of capital arbitrage, but that is what hedge fund managers do, not good managers of shareholder capital. In reality, such companies are only assuming more financial risk, which will not be a problem, until it is. In the meantime, growing earnings per share may lead to over confidence (through the illusion of wealth creation) that the business is on firmer ground than it really is. When the highly leveraged business hits a bump in the road, it may not be in a position to successfully weather the storm. Additionally, if the competition gets tougher, the business may not be in a position to invest capital to produce competitive products due to capital being consumed by debt payments. We have seen this happen many times, and companies often fail when managements use debt to fund an illusion.

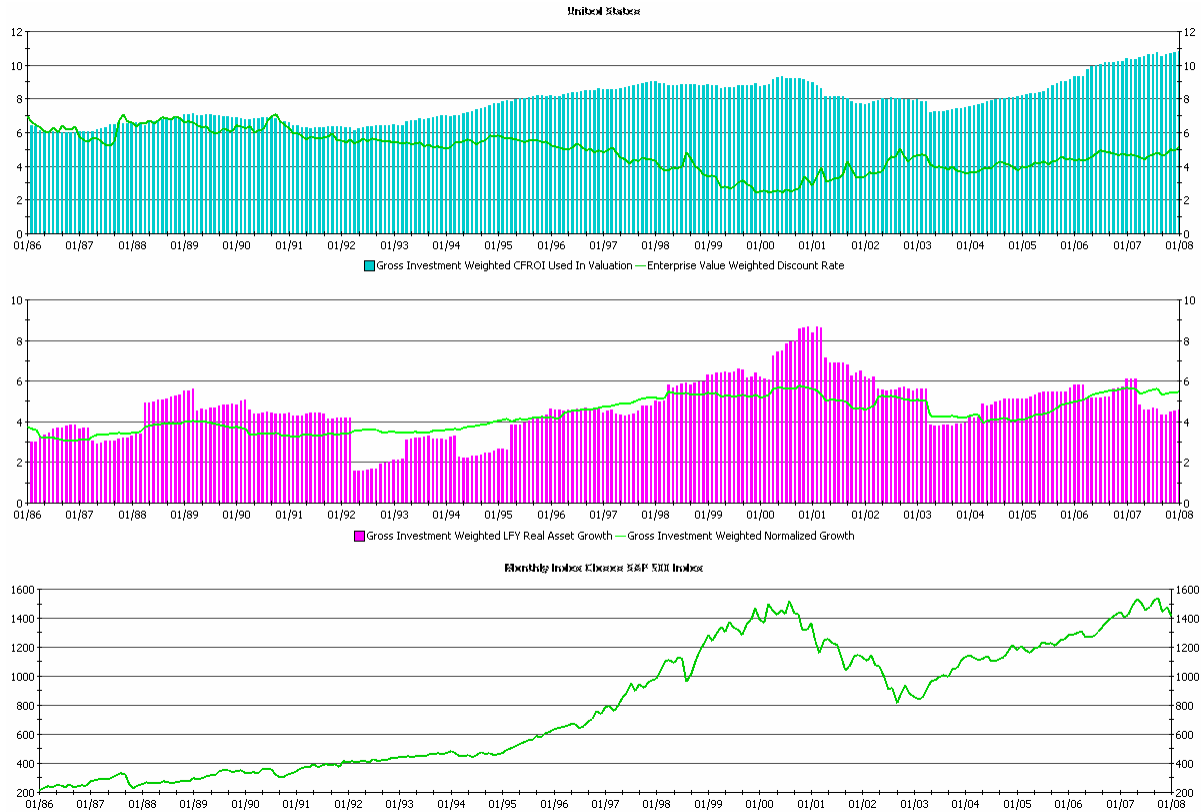
When there is widespread confusion between wealth creation and wealth transfer and systematic increases in debt willing to fund non-wealth creating activity, widespread misallocation of capital can occur, and the self correcting mechanism of capitalism will engage. This is indeed what has occurred in the United States with the current housing and credit crisis. Fear not. Financial crisis serves an important role in clearing out the bad agents and poor allocators of capital, which is the equivalent of weeding the garden so that the beautiful flowers have more nutrients and room to grow.

We see financial crisis emerge every few years. In my 20+ year investment career alone, there has been the failure of portfolio insurance which led to the 1987 crash, the Russian Debt Crisis, the Asian currency crisis, the bursting of the Tech bubble, the bursting of the mega cap bubble, financial scandal crisis (Worldcom, Enron, Adelphia). Our team has grown to no longer fear financial crisis, but to appreciate the important role a crisis serves within the context of pruning the garden of capitalism to allow for new growth, innovation and wealth creation. Google rose out of the ashes of the tech meltdown. Financial crisis is good for the long-term health of the system, and, as long-term investors, we prefer to buy during periods of crisis because companies that are good allocators of capital can be purchased at very attractive valuations, raising our expectations of future returns from the portfolio.

We are currently in the throes of a financial credit crisis, which was brought on by a huge misallocation of capital funded by massive increases in debt used to fund illegitimate wealth transfer strategies based on the illusion of wealth creation. This occurred because of the confusion between wealth creation and wealth transfer by multiple participants including homeowners, mortgage lenders, investment bankers, credit rating agencies, investors and regulators. Homeowners were fooled by the illusion of wealth creation and continued to use their homes as ATMs, borrowing against phantom wealth. Mortgage lenders helped create the illusion by intentionally misrepresenting the credit worthiness of borrowers to investors and misrepresenting the terms of the loan to unsophisticated borrowers, justifying their actions by “helping people live the American dream.” Investment bankers helped sustain the illusion by using sophisticated risk models to package low quality debt and misrepresenting it as high quality debt and selling it to investors. The credit agencies certified the illusion by awarding high investment grade credit ratings to the packages of debt because they were dazzled by the investment bankers’ risk models and were assured through guaranties by the entities associated with various commercial and investment banks who were promoting new “innovative” Structured Investment Vehicles (SIVs). Certain investors in these SIVs engaged in what they thought was a wealth creation strategy, which, in reality, was only a leveraged wealth transfer strategy based on the illusion that they could borrow at rate that reflected low risk and invest those borrowed funds in an SIV that offered a return above the borrowing cost while taking on “no” more risk (remember the credit agencies ratings said there was no more risk). Bear Stearns and several other hedge funds and financial institutions were reminded the hard way that leveraged wealth transfer strategies are not viable long-term strategies, particularly when you are not compensated for the risks you take. Many of the impressive historical “gains” these investors posted disappeared into the abyss as the reality of the illusion came into focus. Regulators, who are responsible for maintaining the integrity of the capital markets, were slow to understand that financial “innovation” was really “SINnovation,” which promoted a leveraged wealth transfer strategy that morphed into an illegitimate wealth transfer strategy leading to a disappearing risk premium and a systematic misallocation of capital.

Which brings us to the question we ask almost every year, but we need to ask it a little differently now...

How will the credit crisis impact corporate profitability and growth?



Source: Credit Suisse HOLT ValueSearch™ Aggregate Relative Wealth Chart (Data date: January 4, 2008)

The quick answer is that most certainly, CFROIs will have to fall as capitalism's self-correcting mechanism takes out poor allocators of capital and the beneficiaries of the illusion of wealth creation.

For several years now, we have been commenting on the incredible boost in corporate profitability and asking ourselves, "How sustainable is it?" In hindsight, it was (is?) a lot more sustainable than we recognized. What we failed to fully comprehend is just how powerful and persistent the structural positive forces contributing to record-level corporate profitability may be.

Structural positives contributing to above-average corporate profitability (LONG TERM):

Capitalism's Triumph over Communism: Since the fall of communism, the principles of economic freedom are gaining acceptance around the world. Approximately three billion people are beginning to experience the benefits of economic freedom. The benefits of economic freedom are undisputed when viewed in terms of life expectancy, income levels of the poorest, income per capital, and economic growth.

Consider the following statistics compiled by the *The Economic Freedom of the World: 2007 Annual Report* published by The Fraser Institute.

<u>Economic Freedom</u>	Income per Capita	Economic Growth	Poorest Income	Life Expectancy	Clean Water	Sanitation
Most Free	\$26K	2.3%	\$7.3K	78.7	99%	97.8%
Second Most	\$10.7K	1.8%	\$2.6K	69.9	90%	77.2%
Third Most	\$6.1K	2.0%	\$1.5K	64.8	82%	61.5%
Least Free	\$3.3K	0.4%	\$0.9K	56.7	72%	53.0%

Globalization: As the number of participants in the global free market system expands, the benefits of comparative advantage expand, leading to further productivity increases, further innovation and greater global wealth creation.

Innovation: The internet bubble burst in March 2000, but from the ashes several business models have emerged, which have changed the way we live, operate businesses, communicate and create. Technology continues to drive massive productivity increases and has yet to reach its full potential.

Longer term, the spread of economic freedom, globalization and innovation will continue to unleash an explosion of global wealth creation. However, the path will not be steady and secular trends will bump into cyclical headwinds when misallocations of capital occur.

Cyclical negatives will drag down CFROI^{®3} and growth in the near term:

Credit Crisis: Commercial banks, mortgage lenders, title companies and many financials are directly or indirectly exposed to the current crisis, and profitability is rapidly deteriorating. Financials represent approximately 20% of the market capitalization. If the market clearing process is allowed to function as it should, financials should represent less of the market before they recover.

Consumer Spending: Clearly, there are several consumer-related companies that have indirectly benefitted from the illusion of wealth creation. The invisible hand must be allowed to clear the market of poor allocators of capital. As that occurs, above-average returns of companies that benefitted from consumer spending based on the illusion of wealth creation should, on average, begin to fall towards the cost of capital. The least skilled allocators of capital among companies that compete for consumer spending may not survive. Obviously, homebuilders were the first to drop.

³ CFROI is a registered trademark in the United States and other countries (excluding the United Kingdom) of Credit Suisse or its affiliates.

Case Study: Hovnanian Enterprises Inc. (HOV)



Source: IronBridge Capital Management, L.P.'s Alchemy (v1.5.2.2)

Homebuilders are mature and cyclical and should earn economic returns approximately equal to the cost of capital over the cycle. This was the case until 2000. Then, due to financial innovation, the structure of lending changed from a principal model to an agency model. Easy credit led to increased demand for housing. Increased demand led to increased prices for housing. Hovnanian Enterprises and other homebuilders experienced an unsustainable windfall, driving profitability up to 18% CFROI. Hovnanian's share price followed increasing from \$3.26 up to over \$70. Increased prices signaled homebuilders to increase investment, significantly increasing housing supply and leading to a misallocation of the economy's resources (too much debt tied to home values and too many homes). The flaw in the agency model was that since the mortgage originators were not responsible for receiving principle and interest payments over the life of the loan, the quality of credit being created significantly deteriorated. The result was an inevitable rise in default rates and a collapse in credit creation, a collapse in demand for housing, and a collapse in the prices of homes and homebuilders. Today, as the market begins to price risk more rationally and the financial crisis right sizes the market, Hovnanian's shares are trading closer to \$5. The *illusion of wealth creation* collided with the *reality* of long-term wealth creation.

Big Unknowns in 2008:

Global growth - The expansion of economic freedom has contributed to above-average corporate profitability and should continue to be a positive influence over the long term. How much can international growth make up for the deteriorating U.S. consumer?

The Great Unwind or Reflation - The pruning process requires a deleveraging of the system and a clearing of the poor allocators of capital. However, if the deleveraging process results in a vicious deflationary cycle, governments may try to reflate by printing money leading to an extension of other forms of financial innovation.

Government Intervention - Japan stayed mired in deflation because poor allocators of capital were kept alive by government subsidization. If governments bail out financial institutions and individuals who fell for the illusion of wealth creation and participated in the illegitimate transfer of wealth, poor allocators of capital will remain in the system potentially inhibiting significant recovery. Any bail out ultimately results in another illegitimate transfer of wealth from the taxpayer to the poor allocators of capital. It is noteworthy that the two days this past quarter with the worst relative performance for the portfolio were 1) the day that President Bush announced a plan to freeze rates on adjustable rate mortgages and 2) the day that European banks announced a \$500 billion injection into the world financial markets.

Big Concerns in 2008:

China - The jobs for profits trade is unstable in the long term because it is an illegitimate transfer of wealth. It is illegitimate because China has pegged its currency to the U.S. dollar, thereby distorting the market price of global labor. As highlighted before, below market prices for labor translates into higher profits for U.S. corporations. This is an illegitimate transfer of wealth from Chinese laborers to U.S. corporations and ultimately transfers wealth away from U.S. workers, who are becoming unfairly priced out of the global market. As the U.S. unemployment rate approaches 5%, political pressure is building to do something. China is responding by allowing the Yuan to float in a wider range and by instituting measures to slow China's growth, which may begin to dampen the beneficial effects of the jobs for profits trade, which has partially contributed to above-average profitability. Since the trade is an illegitimate transfer of wealth, it is unsustainable and will therefore eventually break down. When, is anyone's guess.

Inflation - Part of the monetary effect of the jobs for profits trade with China is a situation where the U.S. has been importing deflation from China, while exporting inflation to China. If the jobs for profits trade breaks down, does that infer a spike in U.S. inflation?

Yen Carry Trade - Perhaps the largest confusion over wealth creation and wealth transfer is the Yen Carry Trade. Investors borrow in yen, because yen is practically free of cost, and then use the proceeds to invest in every other asset class in the world in weights that reflect the greatest chance to achieve the highest return with the least risk. Investors encouraged by their sophisticated Mean Variance Optimization Models may be overconfident with their use of leverage and if the yen strengthens too much, the trade may break. Because this is such a

popular trade, valuations of “uncorrelated” assets in recent years have been driven by lower discount rates rather than changing expectations about future net cash receipts. Therefore assets that historically have been uncorrelated have started to correlate. What will happen if everyone figures out they have to de-lever and reverse the trade at the same time? Let’s just say we would view that as a great long-term buying opportunity.

Investment Implications

As usual, even though we think we understand what is driving the markets, we recognize that the future remains unpredictable. How regulators, investors, political leaders and markets ultimately respond may be very different in terms of timing and magnitude than we expect. For example, we expect that the self-correcting mechanism of capitalism should clear out the bad agents, but it is possible that politicians give them new life through subsidization, new laws or reckless monetary policy. Therefore, our investment strategy stays constant. We invest in companies that are good allocators of capital and have a high probability of beating expectations implied by their share price. We control the risk of the portfolio by diversifying by both industry and Life Cycle. We expect the IronBridge Innovators (Rockets and Golden Goodies) to potentially outperform, but if they do not, our Corks and Turn Arounds will keep the portfolio in the hunt.

Outlook

Last quarter’s cautious outlook was justified. We remain cautious this quarter as it is clear to us that the self-correcting mechanism of capitalism has more work to do to clear out poor allocators of capital. We expect volatility as the reality of lower CFROIs and lower growth collides with the political knee-jerk reactions to “do something.” We suspect that the more the government does to bail out the poor allocators of capital the more difficult it will be for us to outperform because it will keep alive the forces that led to a systematic misallocation of capital, and we do not want to bet on those players for the long term. Perhaps the government will bail out the “Countrywide Financials” of the world, but we do not invest based on the philosophy that poor managers of capital get bailed out by taxpayers. We invest based on the philosophy that good managers of capital will create the most wealth over the long term.

We remain confident that our disciplined investment approach and internally-developed investment tools will help us take advantage of market volatility as the market struggles with the near-term cyclical headwinds and the uncertainty regarding the most recent credit crisis.

Thank you for your continued support.

Kind regards,



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