



January 2009

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

“I predict future happiness for Americans if they can prevent the government from wasting the labors of the people under the pretense of taking care of them.”
-Thomas Jefferson

Dear Fellow Investor,

As we are all painfully aware, the broad, global, decline of financial assets accelerated during the fourth quarter of 2008. Due to the continuous unwinding of financial innovation, credit markets froze and cut off the lifeblood of global investment and consumption. The U.S. government responded by upping the taxpayer’s ante and committing roughly \$4 trillion of taxpayer money to various bailout programs to “take care of” the problem. This commitment is up from a shocking \$800 billion last quarter. Like King Canute’s vain effort to hold back the ocean tide, our government leaders’ belief in their power to stem the financial tide is proving illusory.

Other than cash under the mattress, or Treasury debt, there was no place to hide. In the fourth quarter, the Russell 2000^{®1} Index fell 26.12%, while our Small Cap Core Equity Composite² fell 25.11% net of fees³. As participants in the overleveraged global financial system continued to sell assets in order to bring leverage down to a more manageable level, other indices and asset classes experienced similar declines.

The calendar year 2008 will go down in history as one of the worst stock market declines in over a century. The MSCI World Index declined 40.71%, the S&P 500 declined 37.00%, and the Russell 2000 declined 33.79%. Our composite declined less, 31.33% net of fees, for the year. However, there is not much comfort, or satisfaction, in knowing that we met our objective of outperforming the benchmark while posting a decline of this magnitude.

¹ 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.

² This Supplemental Information supplements the Small Cap Core Equity Composite presentation (as provided on pg. 10).

³ Net of fees returns are after trading expenses and less our management fee. The standard management fee is 1.00% of assets. Net returns are computed by compounding monthly. Past performance does not guarantee future results. Returns reflect reinvestment of dividends, gains, and other earnings. Returns for periods longer than one year are annualized. Annualized performance figures assume steady compounding, while actual results fluctuated over time.

On the other hand, it is helpful to remind ourselves that since April of 1999, when we started the Small Cap Core strategy, our composite’s annualized performance is 8.35% net of fees versus 2.81% for the Russell 2000 Index. And, that includes two of the worst bear markets in generations.

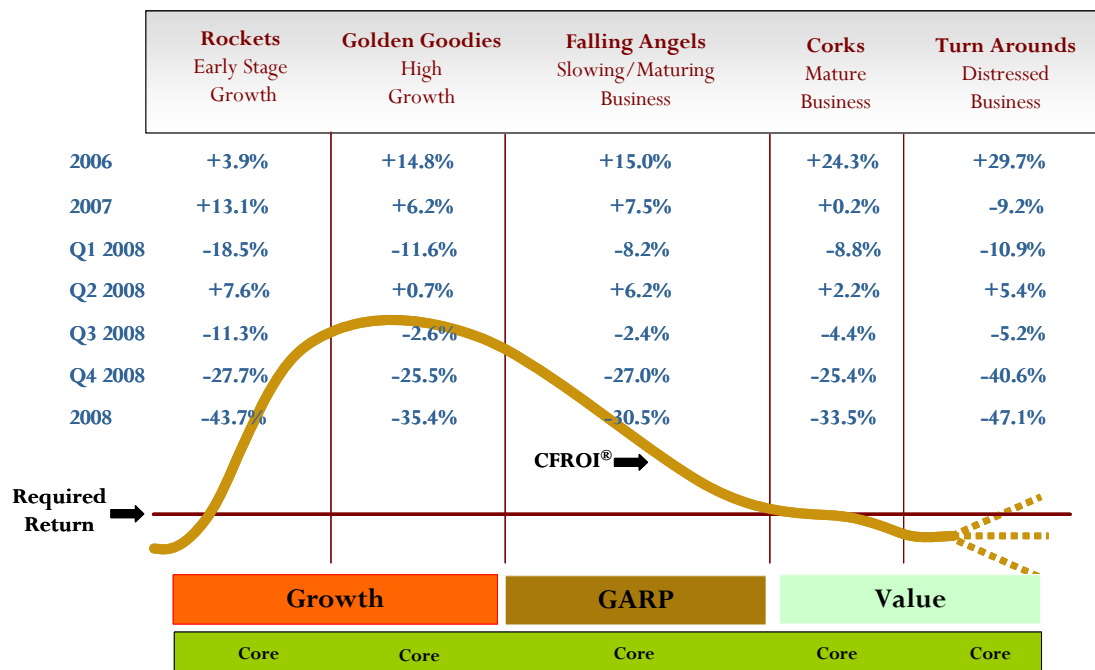
We need to keep in mind that bear markets are a natural, and necessary, component of investing. They are required in order to right financial wrongs, clear out excess, and remind stewards of capital of the importance of trust and integrity to the proper functioning of capital markets. They also make us ask the question, “What went wrong?” and motivate all who have a stake in the system to seek ways of doing things even better in the future.

Fourth Quarter Performance Attribution

The IronBridge portfolio outperformed the Russell 2000 Index by approximately 100 basis points in the fourth quarter. Stock selection was fairly strong among our Information Technology, Consumer Discretionary, Materials, and Consumer Staples holdings; but weaker among our Financials, Health Care, and Industrials holdings. As previously noted, there was nowhere to hide as widespread selling dominated the marketplace. According to our attribution analysis, the net contribution of our stock selection for the quarter was neutral, while our 4% cash allocation accounted for most of the outperformance.

In actuality, we think our stock selection was better than the attribution analysis gives us credit for because we did a good job of benefiting from the volatility. Thanks to volatility, we were able to acquire ten new names this quarter at very attractive entry points. These new names represent seven of our ten best-performing stocks this quarter and were up an average of 16%.

Life Cycle Returns – Russell 2000® Constituents by Life Cycle



CFROI® 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.

From a Life Cycle perspective, the Rockets and Turn Arounds experienced the greatest declines for the year. There are several reasons for this. Rockets behave like long duration bonds because so much of their present value is associated with distant cash flows. Therefore, they are much more sensitive to changes in the investors' discount rate. In 2008, the investors' discount rate increased an unprecedented 2.5%, from roughly 4.5% to 7%. This increase punished high duration stocks relatively more than other stocks. Additionally, Rockets consume capital as they launch their businesses, and capital became scarce due to the credit crisis. The fear is that many Rockets may have difficulty getting access to capital, or capital may be so expensive that existing shareholders may get significantly diluted. At the other extreme of the Life Cycle are Turn Arounds, which often carry high debt loads. The frozen credit markets have made refinancing low-grade debt significantly more expensive as credit spreads have blown out from less than 100 basis points to more than 1000 basis points.

The Sand Pile Game: Avalanche, not Adjustment

In the April 2007 letter, we discussed similarities between markets and sand piles. The sand pile research referred to how scientists study the build up and inevitable collapse of sand piles. They observe one grain at a time in order to better understand complexity theory. A complex system has several features that are consistent with both sand piles and markets:

- 1) Complex systems involve a large number of interacting elements.
- 2) These interactions are non-linear so that minor changes can produce disproportionately major consequences.
- 3) A complex system is dynamic, greater than the sum of the parts; and a solution cannot be imposed; rather, it emerges from the circumstances.
- 4) The system has a history; and the past is integrated with the present; evolution is irreversible.
- 5) While the system may appear ordered and predictable in retrospect, hindsight does not automatically lead to foresight because the external conditions and systems constantly change.

As the scientists dropped one grain at a time to build a sand pile (a market), each grain of sand dropped represented an historical event. As the grains collected, they organized into a unique critical state (markets) riddled with "fingers of instability" of all possible lengths and sizes. Tension grew (markets get stretched). Eventually one of the fingers of instability founders and gives way (the market collapses). Depending on the size and length of the complex network of fingers of instability, anything can happen as physical laws of gravity interact with the critical state of the pile. In this case, it was an historic bear market with significant economic consequences.

One of the most frustrating lessons learned is that accurately predicting the timing and magnitude of outcomes is difficult to impossible. This is because history can never be washed away, and it affects the future of dynamic, complex systems.

In the same letter, we commented on the sub-prime "adjustment," and embraced it as a normal, hopefully minor, but necessary, adjustment that enables markets to climb. But, in this instance, we were wrong. The adjustment turned out to be a \$5 trillion avalanche as the fingers of instability

were longer and deeper than a few \$100 billion of sub-prime debt. What we did not fully understand then is that the sub-prime “adjustment” was really the beginning of a junk credit based avalanche.

While we understood the nature of the housing bubble and anticipated the meltdown in the mortgage, homebuilding, and consumer sectors, we did not fully appreciate the extent of low quality credit that was being created throughout the global financial system, nor the tax incentives that drove its massive growth. Sam Eddins, IronBridge’s Director of Research, has done seminal research into the root causes of the financial crisis. His findings indicate that tax policy distorted profit incentives. We hope to publish these findings eventually; however, here is the bottom line. The existence of taxable vs. nontaxable investors, combined with differences in tax treatment for income vs. capital gain (loss), created a massive tax arbitrage opportunity that actually incentivized the creation of low-quality credit. We call Sam’s insight the Tax Arbitrage Feedback Theory (TAFT).

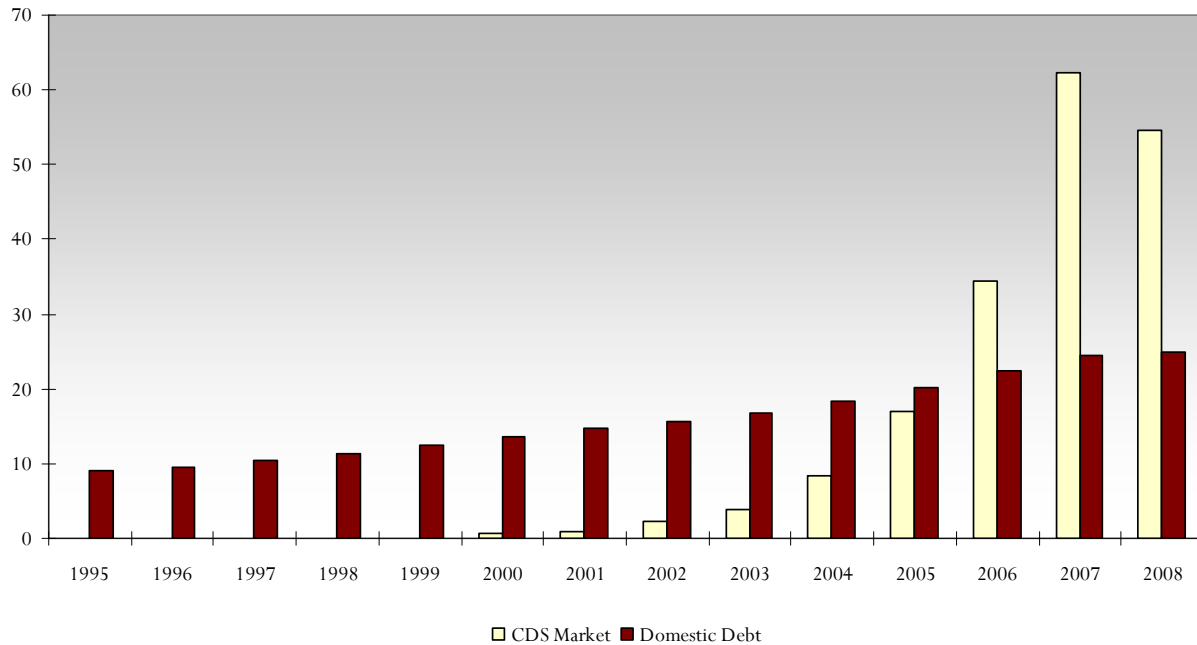
Investopedia defines arbitrage as the simultaneous purchase and sale of an asset in order to profit from a difference in the price. Most arbitrage opportunities are short-lived, as the simultaneous buying and selling of the asset eliminates the arbitrage opportunity. The tax arbitrage is different because it could not be eliminated by price moves. Sam’s paper describes this in more detail. Creative Wall Street investment bankers figured out how to easily exploit this tax arbitrage through the creation of Credit Default Swaps (CDS). A credit default swap is a swap designed to transfer the credit exposure of a fixed income instrument to another party by guaranteeing the principal of the instrument. The creation of a CDS market was a wealth transfer strategy, transferring wealth from government coffers into Wall Street bonus pools. Credit Default Swaps behave like insurance policies against loss of principal on a bond and, for simplicity, may be expressed as a percentage of the bond’s yield.

Let’s say you are a taxable investor and you own some corporate bonds yielding 9%, and you worry that you won’t get your principal back. You go to Goldman Sachs and they will sell you a credit default swap for 4%, which lowers your effective yield to 5%, but you are still happy because 5% is a little better than a government bond, and you have laid off the default risk to Goldman Sachs (free lunch, higher return with less risk?). If you, the taxable investor, didn’t buy the credit default swap and the bond defaults, you could lose 85% of your principal. In this scenario, you would lose only 85%, rather than 100%, because of the tax benefit associated with a capital loss at current capital gains tax rates of 15%. (For the sake of clarity, we are assuming 0% recovery rates.) However, if you are Goldman Sachs, and the bond defaults, you would lose just 60% since Goldman Sachs (and others) is recognized as a “market to market business trader” by the IRS and can offset the capital loss at a 40% tax rate.

Remember, arbitrage is defined as profiting from a simultaneous purchase and sale of the same asset, which sells at different prices. In this case, the asset is the tax benefit associated with a capital loss. How does the tax benefit asset get priced differently? Answer, the tax code. Remember, the IRS offers different treatment (15% for taxable, 0% tax free and 40% for market to market business traders), so they have effectively created different prices for the same asset. Once Wall Street bankers figured this out, the growth in the CDS market exploded and became the new profit engine for their businesses. So profitable, that \$300 billion of CDS insurance has been sold to

cover \$30 billion of General Motors debt. If you bought a house for \$100,000, would you insure it for \$1,000,000? Of course not, unless you were planning to burn it down. In 1999, the CDS market was virtually \$0. Today, the CDS market stands at an estimated \$60-\$70 trillion. Estimated, because there is no transparent market where CDS trade and disclosure is on a voluntary basis.

CDS Growth (Trillions \$) – Debt / Securitized



Source: IronBridge Capital Management, L.P.

Note that tax arbitrage does not exist in high-quality credit because the odds of default are so low that there is hardly any tax benefit associated with a capital loss asset to arbitrage. Therefore, the creation of low-grade credit was required to take advantage of the arbitrage. The profitability of this trade provided feedback to incentivize the creation of even more low-quality debt. This drove a credit-based liquidity boom. Everyone had access to cheap capital, whether he or she could pay it back or not. Unfortunately, many market participants and regulators interpreted the subsequent narrowing of credit spreads as a reduction in default risk. Credit default swaps were hyped as a new frontier in risk management, for which “distributed risk” lowered the cost of capital to corporations and provided investors a higher return with less risk. However, the reality was that the rapid growth in low-quality debt was increasing default risk, and the only reason the cost of capital was lower was due to the porting of the tax benefit. Furthermore, as far as risk is considered, nobody understood or considered the possibility of counterparty risk, which is why when Lehman went bust, all bets were off.

Wealth Creation, Wealth Transfer, and Debt

Previous letters have brought attention to the confusion by investors over wealth creation vs. wealth transfer. Sam’s TAFT research sheds more light on this topic by showing how bankers simply responded to government tax incentives. These incentives drove a transformation of banking

business models from enablers of wealth creation (old-fashioned investment banking) to speculative, leveraged, wealth transfer models (the hedge fund model).

It is important to understand the difference between wealth creation and wealth transfer. Wealth creation is the expression of productivity and innovation. Together, they drive standards of living higher. Therefore, legitimate wealth creation drives higher standards of living for most of society. But, wealth transfer, by definition, transfers wealth from one party to another, and does not result in a higher standard of living. Rather, one group benefits at the expense of another. Social Security is a wealth transfer tax from the productive (working) to the unproductive (retired) and, therefore, does not contribute to increasing the standard of living for all of society, but rather enriches the old at the expense of the young.

Confusion over wealth creation versus wealth transfer led to a mass misallocation of capital towards leveraged wealth transfer strategies at the expense of wealth creation strategies. Debt complicates the wealth creation versus wealth transfer equation because debt is a double-edged sword. One blade is virtuous while the other is vicious. How debt is applied determines whether the sword serves you or slays you. For example, debt transfers cash flows from future productive activity to the present. Debt can be virtuous if one properly matches debt taken on today plus the time value of money of future wealth created. In this case, debt serves a valuable function by smoothing the need for consumption today with the ability to produce tomorrow. When applied to wealth-creating activity, debt can also be a great stimulus. If debt is used to invest to produce or innovate, so that the wealth created over time exceeds that which was borrowed plus borrowing costs, wealth is created.

New wealth created that is not consumed gets recycled into other productive or innovative activity, driving a virtuous cycle of wealth creation and higher standards of living. However, debt is vicious if used to consume more than the borrower can realistically produce in a lifetime, or if invested in unproductive, wealth-destroying activity, when it cannot be repaid. Such a scenario leads to forced asset sales to pay off debt, which drives asset prices lower, triggering more asset sales, driving a vicious cycle of wealth destruction. Sound familiar? Properly functioning markets limit the creation of debt directed toward wealth-destroying activity, as pure self interest and the desire to profit typically restrict uneconomic lending. As a result, the net wealth created by virtuous cycles exceeds wealth destroyed by vicious cycles over time. Thus, each new sand pile grows higher following a collapse and higher standards of living resume their ascent.

Markets Will Go Higher as New grains (Innovation) Drop on the Collapsed Sand Pile

Clearly, we are currently working through challenges associated with a vicious cycle. The sand pile research teaches us that history affects the future of dynamic systems. In my entire life, I can't think of a more economically historic year than 2008. IronBridge is actually relieved that recent dramatic events have exposed dangerous financial practices, unsound and downright fraudulent business models, fraudulent people, and just plain naïve assumptions about markets and finance. Those who have capital, or are responsible for allocating it, are rediscovering the essential financial truths about how markets work. Therefore, they are more likely, going forward, to be more prudent with capital.

Market participants, regulators, and politicians will seek to learn the lessons of this historic year, which offers us the opportunity to positively impact the future of our economic system. There are many lessons to be learned from last year's crisis. Some lessons are old and should never have been forgotten. Some are recent and should have been understood sooner. They are not comprehensive, but represent some of the lessons we hope all stewards of capital will embrace, whether they be investors, regulators, politicians, or concerned citizens.

1) *"There is no such thing as a free lunch."* The sophisticated products that promised higher returns with less risk that were offered by hedge funds and various innovative financial structures like CDOs and SIVs have now been exposed for what they are. They are either higher returns with higher risk, or lower returns with lower risk, but never higher returns with lower risk.

2) *"Don't lend to people/businesses that can't pay you back."* When we first observed this phenomenon, we could not believe it. Now we understand that the only way WAMU, CountryWide, and others could get away with this was through Government Sponsored Entities (GSEs) like FNMA, and the securitization, and CDS markets. The excess creation of junk debt required naive investors and irresponsible borrowers who have now lost so much money they have no more to invest. Therefore, they have effectively been removed from the market. The good news is that the only loans being made today are to highly credit worthy borrowers with pristine credit credentials (unless they are part of the Homeowner Relief Act). Real credit creation is of much higher quality today and that bodes well for future default rates.

3) *"The FNMA and other GSEs introduce moral hazard and must be modified. It is not good government policy to have the U.S. government guarantee privately-created, low-quality debt while encouraging that same government-sponsored entity to seek profit."* For certain, FNMA and Freddie Mac will look very different. In effect, they already have been nationalized. In the future, they will be much smaller and less profitable, if they exist at all. Management will be compensated much lower, like a government employee rather than like a hedge fund manager.

4) *"Markets require trust and integrity to function properly."* Those who lack trust and integrity have been exposed by the bear market and are not likely to reappear any time soon. Today's capital providers and regulators are much more likely to demand proof/verification that such institutions operate in a way that does not violate principles of trust and integrity. Business models that temporarily profited by violating trust and integrity have been destroyed.

5) *"Transparency and feedback loops are required for efficiently functioning markets."* Credit markets remain frozen because of the heightened awareness of counterparty risk. Of the \$70 trillion in credit default swaps, nobody knows who is holding what, and, therefore, how solvent the others are. Illiquid assets in CDOs and SIVs can't be liquidated because the structures are opaque, and therefore, hard to value. Currently, the remaining Wall Street banks are trying to create transparent markets for the credit default swap markets through partnership with ICE exchanges in either Chicago or New York. Similar efforts are underway to unwind the CDO markets in a more orderly way. Regulators hope that once transparency is brought to these markets, assets should clear, and credit should begin to flow again.

6) *“Quantitative risk models cannot identify true risk because they cannot identify liquidity, tax impacts, and changes to the underlying structure of markets.”* Markowitz, the father of modern portfolio theory, upon which most risk models are based, had already warned of these unseen risks. Practitioners and regulators are now much more aware and will seek to adapt current models to incorporate these risks and certainly carry less debt, given these risks are hard to manage.

7) *“Overly complex tax policy distorts efficient allocation of capital.”* This will hopefully be one of the most important lessons to come out of the analysis of this crisis. However, it will take time. This is a highly charged issue, involving many interested parties. We think Sam’s research paper will demonstrate that almost every historic bubble was strongly linked in part to unnecessarily complex tax policy. We believe the current credit crisis would not have happened under a flat tax where all market participants are treated equally for tax purposes. This lesson seems to be taking a long time for politicians and regulators to understand.

8) *“Diversification only works when net cash receipts are diversified. When everyone diversifies based on past price performance, and liquidity drives price instead of net cash receipt forecasts, diversification no longer works.”* Major pension funds and foundations have learned this the hard way and have already started to reduce allocations to alternative assets. Presumably, they will reallocate to the roots of wealth creation, and that is the debt and equity markets.

9) *“Research Matters.”* Part of the problem was that investors relied on credit ratings and new risk management tools rather than old-fashioned equity or credit analysis. Equities were viewed as baskets rather than individual stewards of economic capital. The flaw of buying “cheap” indices or ETFs as a substitute for highly researched portfolios and thoughtful allocation of capital to deserving managements should be obvious as indices and ETFs blindly bought AIG, Citigroup, Countrywide Financial, Lehman Brothers, Bear Stearns, IndyMac, etc. simply because they were part of a basket rather than judging them on their individual merits. Those who followed the insightful research of Meredith Whitney, who was early to expose the magnitude of the credit and solvency issues associated with Lehman, Bear Stearns, and others, benefitted by selling these securities before they lost all of their value while ETFs and Index funds purchased these insolvent companies even as they kept dropping.

This letter covers important issues, but there are even more lessons that will arise. The point is that bear markets expose flaws. The natural state of human beings is to innovate and to improve in order to emerge stronger. And we will emerge from this crisis stronger, setting the stage for new growth, and the sand pile will once again grow high.

The IronBridge Outlook: Volatility

Markets will most likely remain volatile; but we view that positively. We think investors spend too much fruitless effort trying to reduce volatility. Volatility merely reflects collective uncertainty. Perhaps volatility became misunderstood when investment time horizons got so compressed. Maybe volatility is not the enemy. Maybe volatility should be viewed as the natural outcome of the competition for capital as the market sorts out winners and losers. Volatility and bear markets are a necessary part of achieving long-term investment objectives. Since starting IronBridge’s Small Cap Core strategy in April 1999, my original investment in the product has been down at least 10%

within a ten-month period at least seven times over nine and a half years, while posting an 8%+ annualized return. If viewed through a short-term, twelve-month lens, the volatility is frightening and stressful. However, if viewed through a long-term lens, and a deeper understanding of the proper role of capital markets, one begins to appreciate that volatility and bear markets serve an important role in weeding and pruning the forest so new growth can occur, creating opportunities. Enron and WorldCom come to mind as a few weeds that had to go in the 2002 bear market. Google comes to mind as a new growth opportunity that rose out of the ashes of the tech bust.

In IronBridge Capital Management's strategizing, volatility is opportunity, not a problem, because we are long term and not leveraged. We benefit from buying extremely well managed companies at distressed valuation levels, at the expense of over-levered speculators who are forced to liquidate in order to pay off their debt. Granted, over-levered speculators are setting prices today and the economy is negatively impacted by the economic carnage left by their actions. However, we believe the ultimate long-term beneficiaries of the current financial crisis must be equities when markets settle back into "normalcy." Long-term treasuries yielding 2.5% looked pretty smart for 2008, but we doubt they will by 2018 after nearly \$5 trillion (and counting) of government bailout money hits the monetary base over the next several years.

We believe equities provide the best long-term return and provide an inflationary hedge relative to cash or bonds. This is because equities will participate in the wealth created from future human innovation and productivity increases. High-grade bond returns capture only promises to repay from existing levels of productivity (cash flow). Although they offer a more predictable return, high-grade bonds often lag behind equities over the long term because they do not participate in future wealth creation, nor do they protect against inflation. Government bonds fail to provide any real after-tax return over the long term because the source of their cash flow is not linked to any form of productivity, but rather to wealth transfer by taxing productivity, with no principal risk, due to the government's monopoly on the power to tax and/or print money. Therefore, we think the best investment for the long term is equities, despite the anticipated near-term volatility. Buy low. Sell high. Right?

Our strategy never wavers. It is to invest in companies that are good stewards of shareholder capital and that are likely to exceed long-term expectations implied by their current share price. Today, the environment is challenging for sure, but we believe our unique economic framework and life cycle approach to investing puts us in a position to benefit from volatility for the long-term benefit of our clients.

Thank you for your continued support.

Best regards,



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

Small Cap Core Equity Composite

April 30, 1999 to December 31, 2008							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	15.16	14.03	-3.02	<5	NA	16.0	11.8	
2001	18.80	17.63	2.49	<5	NA	24.6	20.8	
2002	-11.88	-12.77	-20.48	<5	NA	61.0	50.6	
2003	48.28	46.85	47.25	<5	NA	521.3	233.6	
2004	19.85	18.68	18.33	22	0.36	1,878.0	1,112.2	
2005	4.37	3.34	4.55	28	0.54	2,692.9	1,343.4	
2006	16.37	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	
2008	-30.62	-31.33	-33.79	26	0.34	3,902.4	943.1	

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 9.43% before management fees; 8.35% after fees; and the annualized benchmark return is 2.81%.
- 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 In the 2008 presentation, some previous years' gross returns were restated by between +0.02% and -0.03%, due to rounding differences in a new portfolio accounting system. Net returns were unchanged.
- 9 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.
- 10 Derivative use within the composite is minimal and deemed immaterial.
- 11 A complete list and description of all IronBridge composites is available upon request.
- 12 Additional information regarding policies for calculating and reporting returns is available upon request.