# Portfolio Review: U.S. Small-Cap Fund

Second Quarter 2010

BROWN ADVISORY

## Portfolio Review and Outlook

The state of macroeconomic events continues to be the dominant factor influencing equity portfolios. The result has been a historically high correlation between individual stock movements and the broader market of approximately 80%. In essence, stock picking has presently taken a clear back seat to market timing. However, correlations of this magnitude tend to be relatively short-lived. As long-term investors focused on fundamental security selection, we believe history will prove a reasonable guide to future behavior.

The second quarter of 2010 was disappointing, particularly given the strong start to the year by our strategy in the first quarter. In sum, the portfolio relinquished all of the out-performance it produced early in the year, finishing the most recent period flat with the Russell 2000 Growth benchmark on a year-to-date basis. Mostly random fluctuations in individual holdings and an overweight in energy heading into the Gulf of Mexico oil spill explain the variation in our returns compared to our broader investment universe. Given our two- to three-year investment horizon, a single quarter is not a statistically significant period from which to judge our stock selection. That said, we do realize that the long term is comprised of a series of short-term intervals, so we attempt to do our best to maximize near-term results without compromising our multi-year investment views.

The only stock-specific items worth highlighting in the quarter were the continuation of a heightened level of M&A activity within the portfolio. Two more portfolio holdings, Sybase and Argon ST, were acquired by strategic buyers in 2Q10, equaling the number of “take-outs” in the first quarter. Although the probability of a strategic buyer unlocking value was considered in each of these investments, the primary consideration upon purchase was the quality of the business model, the capability and honesty of management team, and the sustainability of its competitive advantages. In other words, we attempt to buy sound businesses where internal fundamentals will drive value, attracting suitors; we are not attracted to businesses simply because they are rumored to be “take-out” candidates.

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## Sector Diversification vs. Russell 2000 Growth Index

- Consumer discretionary is significantly underweighted in its traditional components, such as retail and restaurants, as we believe the durability of a recovery in enterprise spend should trump that of the consumer, according to our bottom-up research.

- Energy remains an overweight but is off considerably from its highs as we have adjusted the portfolio to take into account the "unknowables" resulting from the Gulf of Mexico oil spill.

- Health care has grown in weighting as a number of existing portfolio ideas have shown more positive risk/reward characteristics lately.

- Information technology is our largest overweight, but it is comprised of many stable financial processor or business services stocks; thus the weight is not as meaningful as it appears.

- Financials remain significantly underweighted as we continue our search for secular growth businesses without much success.

| Sector | Q2 '10 | Benchmark | Diff | Q1 '10 | Q2 '09 |
|---|---|---|---|---|---|
| Consumer Discretionary | 16.72 | 18.41 | -1.69 | 22.58 | 20.75 |
| Consumer Staples | -- | 3.15 | -3.15 | -- | -- |
| Energy | 5.10 | 3.93 | 1.17 | 10.12 | 5.19 |
| Financials | -- | 5.01 | -5.01 | -- | -- |
| Health Care | 25.07 | 21.41 | 3.67 | 21.95 | 26.33 |
| Industrials | 18.17 | 16.40 | 1.76 | 14.98 | 21.39 |
| Information Technology | 32.09 | 25.63 | 6.47 | 27.14 | 22.67 |
| Materials | 0.96 | 4.58 | -3.62 | 1.64 | 2.00 |
| Telecommunication Services | 1.53 | 1.37 | 0.16 | 1.36 | 1.34 |
| Utilities | -- | 0.11 | -0.11 | -- | -- |

*N.B.: Figures may appear not to add up due to rounding.*
*Source: Brown Advisory*
*Benchmark: Russell 2000 Growth*
*Holdings and allocations are subject to change.*

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## Quarterly Attribution Detail by Sector vs. Russell 2000 Growth Index

| | Portfolio | | Russell 2000 Growth | | Attribution Analysis | | | |
|---|---|---|---|---|---|---|---|---|
| Sector | Average Weight | Total Return | Average Weight | Total Return | Allocation Effect | Selection Effect | Interaction Effect | Total Effect |
| Consumer Discretionary | 20.63 | -21.52 | 18.26 | -12.44 | 0.10 | -1.78 | -0.43 | -2.11 |
| Consumer Staples | -- | -- | 3.60 | -5.91 | -0.11 | -- | -- | -0.11 |
| Energy | 8.55 | -16.37 | 3.84 | -14.54 | -0.29 | -0.06 | -0.03 | -0.38 |
| Financials | -- | -- | 5.72 | -7.99 | -0.07 | -- | -- | -0.07 |
| Health Care | 23.40 | -10.70 | 24.11 | -10.49 | 0.08 | -0.05 | 0.10 | 0.13 |
| Industrials | 16.08 | -5.55 | 14.46 | -6.28 | 0.04 | 0.24 | -0.03 | 0.25 |
| Information Technology | 28.63 | -4.73 | 25.79 | -7.09 | 0.12 | 0.56 | 0.14 | 0.82 |
| Materials | 1.04 | -14.76 | 2.68 | -8.84 | 0.02 | -0.11 | 0.06 | -0.03 |
| Telecommunication Services | 1.38 | -5.71 | 1.34 | -9.63 | 0.00 | 0.07 | 0.01 | 0.08 |
| Utilities | -- | -- | 0.19 | -6.65 | -0.01 | -- | -- | -0.01 |
| **Total** | **100.00** | **-10.80** | **100.00** | **-9.24** | **-0.11** | **-1.14** | **-0.33** | **-1.56** |

*Allocation Effect: Measures the impact of the decision to allocate assets differently than those in the benchmark.*
*Selection Effect: Measures the effect of choosing securities that may or may not outperform those of the benchmark.*
*Interaction Effect: Measures the effect of allocation and selection decisions, i.e. did we overweight the sectors in which we underperformed.*

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## Quarterly Attribution Detail by Sector vs. Russell 2000 Index

| | Portfolio | | Russell 2000 | | Attribution Analysis | | | |
|---|---|---|---|---|---|---|---|---|
| **Sector** | **Average Weight** | **Total Return** | **Average Weight** | **Total Return** | **Allocation Effect** | **Selection Effect** | **Interaction Effect** | **Total Effect** |
| Consumer Discretionary | 20.63 | -21.52 | 15.36 | -14.26 | -0.03 | -1.22 | -0.69 | -1.94 |
| Consumer Staples | -- | -- | 3.14 | -6.41 | -0.10 | -- | -- | -0.10 |
| Energy | 8.55 | -16.37 | 4.67 | -14.34 | -0.18 | -0.07 | -0.11 | -0.36 |
| Financials | -- | -- | 21.30 | -9.51 | -0.12 | -- | -- | -0.12 |
| Health Care | 23.40 | -10.70 | 13.80 | -10.32 | 0.02 | -0.04 | 0.05 | 0.04 |
| Industrials | 16.08 | -5.55 | 15.67 | -7.49 | -0.00 | 0.35 | 0.08 | 0.43 |
| Information Technology | 28.63 | -4.73 | 17.43 | -8.17 | 0.29 | 0.58 | 0.48 | 1.34 |
| Materials | 1.04 | -14.76 | 4.77 | -12.89 | 0.11 | -0.01 | -0.00 | 0.10 |
| Telecommunication Services | 1.38 | -5.71 | 0.85 | -9.05 | 0.00 | 0.04 | 0.03 | 0.07 |
| Utilities | -- | -- | 3.02 | -3.18 | -0.19 | -- | -- | -0.19 |
| **Total** | **100.00** | **-10.80** | **100.00** | **-9.92** | **-0.20** | **-0.38** | **-0.31** | **-0.88** |

*Allocation Effect: Measures the impact of the decision to allocate assets differently than those in the benchmark.*
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## Quarterly Contribution to Return

- Argon ST was acquired by Boeing on the last day of the quarter at roughly a 40% premium. The Company has been a multi-year holding reflecting our belief that management's focus on C5ISR, the highest-growth area in defense spending, would prove to be a boost to long-term growth.

- Sybase was acquired by SAP based upon the stability of its core database software business and the promise of its emerging high-growth mobility division.

- Harman International and Nuvasive both gave back portions of their recent outsized returns. We have questioned whether we should have taken more money off the table based upon near-term vs. long-term risk/reward.

- Oceaneering International has produced solid financial results, but the Company has a significant portion of its remotely operated vehicle (ROV) revenues stemming from the Gulf of Mexico, causing the stock to decline significantly as the severity of the BP oil spill increased.

**Top Five Contributors**

| | Name | Avg. Weight | Total Return | Contribution to Return |
|---|---|---|---|---|
| STST | ARGON ST Inc. | 1.71 | 28.86 | 0.56 |
| SY | Sybase Inc. | 2.23 | 38.70 | 0.56 |
| TTES | T-3 Energy Services Inc. | 1.06 | 22.15 | 0.25 |
| AMCC | Applied Micro Circuits | 1.65 | 21.44 | 0.15 |
| DXCM | DexCom Inc. | 1.01 | 18.69 | 0.14 |
| | **Total** | **7.66** | **25.74** | **1.65** |

**Bottom Five Contributors**

| | Name | Avg. Weight | Total Return | Contribution to Return |
|---|---|---|---|---|
| HAR | Harman Int'l Industries | 3.54 | -36.11 | -1.26 |
| NUVA | NuVasive Inc. | 3.91 | -21.55 | -0.88 |
| OII | Oceaneering Int'l | 2.51 | -29.28 | -0.79 |
| OWW | Orbitz Worldwide Inc. | 1.69 | -46.41 | -0.76 |
| UTIW | UTi Worldwide Inc. | 3.10 | -18.82 | -0.59 |
| | **Total** | **14.76** | **-28.76** | **-4.28** |

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## Key Additions/Deletions

- Consumer discretionary has not been an area of emphasis for our strategy, but we did find four companies where we thought the actual risk to the business was lower than the risk perceived by the market, creating reasonably attractive entry points. These include: AnnTaylor, Blue Nile, Sotheby's and vitacost.com. All of these companies have either significant demand or margin improvement drivers that should result in meaningfully higher valuations.

- Athenahealth and Esco Technologies were eliminated from the portfolio as it became evident that the growth thesis was beginning to break down in each case.

- Gulfmark, T-3 Energy Services and Tidewater in the energy sector were sold in order to rapidly respond to the changing end-market dynamics created by the Gulf of Mexico oil spill. Although the BP spill was the catalyst for the sales, the root cause was the opportunity cost of owning these businesses compared with other alternatives.

**Portfolio Activity**

| | **Additions** | **Sector** |
|---|---|---|
| ATU | Actuant Corp. (Cl A) | Industrials |
| ANN | AnnTaylor Stores Corp. | Consumer Discretionary |
| NILE | Blue Nile Inc. | Consumer Discretionary |
| DRQ | Dril-Quip Inc. | Energy |
| G | Genpact Ltd | Information Technology |
| BLUD | Immucor Inc. | Health Care |
| MSM | MSC Industrial Direct Co. (Cl A) | Industrials |
| BID | Sotheby's | Consumer Discretionary |
| UTHR | United Therapeutics Corp. | Health Care |
| VITC | vitacost.com Inc. | Consumer Discretionary |
| | **Deletions** | **Sector** |
| ATHN | athenahealth Inc. | Health Care |
| CFL | Brink's Home Security Holdings | Consumer Discretionary |
| BR | Broadridge Financial Solutions Inc. | Information Technology |
| ESE | ESCO Technologies Inc. | Industrials |
| GXDX | Genoptix Inc. | Health Care |
| GLF | Gulfmark Offshore Inc. (Cl A) | Energy |
| PETM | PetSmart Inc. | Consumer Discretionary |
| TTES | T-3 Energy Services Inc. | Energy |
| TDW | Tidewater Inc. | Energy |
| WMS | WMS Industries Inc. | Consumer Discretionary |

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