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1Q11 SCV Commentary

## General Market Commentary for the First Quarter of 2011

The US equity market overcame numerous global concerns to post an impressive start to 2011 with the quarter producing returns that count among the strongest starts to a new year in over a decade. Political tension in Northern Africa and the Middle East, the earthquake and resultant tsunami in Japan, continued sovereign debt issues in Europe, and trepidation over the continued economic recovery were among the obstacles the equity market managed to navigate around this past quarter. The trend of small cap outperformance continued as the Russell 2000® Index returned 7.94% as compared to the 6.24% return of the large company Russell 1000® Index. Value stocks, which had less exposure to the outperforming Information Technology sector as well as larger exposure to the underperforming Financials and Utilities sectors, underperformed growth stocks as the 6.6% gain in the Russell 2000® Value Index fell short of the 9.24% gain in the Russell 2000® Growth Index for the first quarter.

Despite all of the macro concerns, correlations at a stock level have continued to moderate. This moderation in correlation frames a market environment that should reward skillful stock selection. As we approach the start of earnings season, it is our belief that corporate earnings will be the key catalyst that ultimately propels shares higher or stalls the rally. Our research continues to confirm the confidence we have in the fundamentals of our companies. We are optimistic that the strength of earnings and unfolding catalysts will allow us to deliver value to our client portfolios.

## Portfolio Commentary

For the quarter ending March 31, 2011, the portfolio underperformed the Russell 2000® Index. The largest detractors to performance were poor stock selection in the Financials and Information Technology sectors. Within Financials, the stock of Assured Guaranty Ltd., a provider of financial guaranty insurance, fell as investors became concerned about the possibility of large scale defaults of municipal bonds. While we do not discount the possibility of individual defaults, we do not believe that defaults will become widespread and we maintain that Assured has appropriate reserves and procedures to successfully manage the current environment. Therefore, we have used the price decline to opportunistically increase the portfolio's investment in Assured. Performance within Financials was also impacted by the decline in the stock of Hersha Hospitality Trust, which operates premium-branded limited service hotels, with a large concentration in the New York City market. Poor weather and an increase in gasoline prices have hindered performance in the seasonally soft first quarter of the year. Hersha remains a holding within the portfolio, but we are monitoring results closely. The Information Technology sector contained the portfolio's two worst performing stocks during the quarter in Anadigics, Inc. and Entropic Communications, Inc. Ironically, both of these stocks were delivered solid returns for the portfolio during the previous quarters. Anadigics, a provider of circuits used in broadband and wireless communication products, met earnings expectations but provided lower guidance due to inventory issues and weakness from one large customer. Despite our belief that Anadigics is well positioned for a recovery in the second half of 2011 due to the introduction of new products and new customers, we sold this stock from the portfolio as we viewed inventory concerns to be of greater near-term significance than what may transpire later in the year. Entropic provides semiconductor chipsets used in cable boxes and other television tuners that enable, among other features, multi-room digital video recording. The Company is the leader in the industry and delivered earnings and guidance in excess of consensus estimates. However, investors became concerned about the entrance of a new provider to this market and sold off the stock on these fears. We exited our position as we could not ascertain the extent to which Entropic would be impacted by this new competitor.

The portfolio benefited by strong stock selection from the Energy sector, which contained the portfolio's two best performing stocks in SandRidge Energy Inc. and Pioneer Drilling Company. SandRidge is an explorer of natural gas and oil whose stock has benefited from the Company's increased exposure to oil primarily through its 900,000 acre position in the Mississippian Horizontal play. Favorable reserve updates and an increase in the price of crude oil propelled the stock in excess of 60% during the quarter. Pioneer Drilling provides land-based drilling services and benefited from increased utilization, in part due to the Company moving underutilized rigs to the Permian Basin, where activity remains robust. Both SandRidge and Pioneer remain in the portfolio as we still find each Company's outlook and valuation attractive.

At the end of the fourth quarter, the portfolio's largest investments were in Wabash National Corp., Goodrich Petroleum Corp. and Cardinal Financial Corp. Wabash manufactures truck trailers and is benefiting from a company-wide restructuring as well as a recovery in the trailer purchasing cycle. After a doubling in the stock price during the second half of 2010, the stock was essentially flat for the first quarter of this year, but was a relative underperformer within Industrials sector. As monthly orders continue to exceed consensus estimates, we anticipate the stock of Wabash National to have a solid 2011. Goodrich Petroleum, an explorer of natural gas and oil, was an absolute and relative outperformer during the quarter as the Company continued to increase its exposure to oil, from natural gas, and delivered production and reserve data that was met favorably by investors. Cardinal Financial provides retail and commercial banking services primarily to the Metropolitan D.C. market. Our investment in Cardinal was an absolute and relative outperformer during the quarter.

**Research Efforts**

We continue to focus our research efforts on identifying companies that have specific near term catalysts whose stocks are currently being undervalued by the market. No matter the macroeconomic environment or current investor sentiment, the universe of small cap stocks is broad such that we are confident our due diligence process will continue to discover attractive investment opportunities.

For current holdings, we remain vigilant in monitoring valuation levels relative to the catalysts that have occurred, or are expected to occur, to ensure that the portfolio contains only the most attractive investments.

**Sector or Industry Shifts**

At the beginning of the quarter, the largest overweight exposure was to the Materials sector. However, a reduction in the size of several of our precious metal stocks and the profitable sale of a fertilizer company investment reduced the overall weight of this sector. While the portfolio still maintains a slight overweight in Materials relative to the Russell 2000® Index, this sector was replaced by Financials as the largest overweight at the end of the quarter. We identified several attractive investments within Consumer Finance and Insurance which served to increase the portfolio's existing overweight positioning to the Financials sector. Health Care remains the largest underweight position; however, investments in a diagnostics company and a services provider increased our Health Care weighting and reduced the extent of the portfolio's underexposure. The largest absolute change in sector positioning occurred within the Information Technology sector where the portfolio moved from an overweight position at the beginning of the quarter to an underweight as of quarter's end. As previously discussed in this letter, we exited several investments in this sector and did not identify suitable replacements.



*The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.*