



*February 2009*

## **Going Back to Basics – The Return to U.S. Growth Stocks**

In 1997, I was compelled to write a position paper regarding the state of the US stock market. The paper entitled “The Small Cap Sector - Is the Pendulum Starting to Swing Our Way?” focused on the idea that small cap stocks would outperform large cap stocks after a period dominated by a “nifty-fifty” environment. The subsequent period resulted in one of the best small cap cycles in my career. Just like the period in the mid 1990s, I believe today the market is on the cusp of a major change in asset class performance. The cheap credit and international market bubbles have burst and investors are poised to reallocate their investment dollars back to U.S. growth equities.

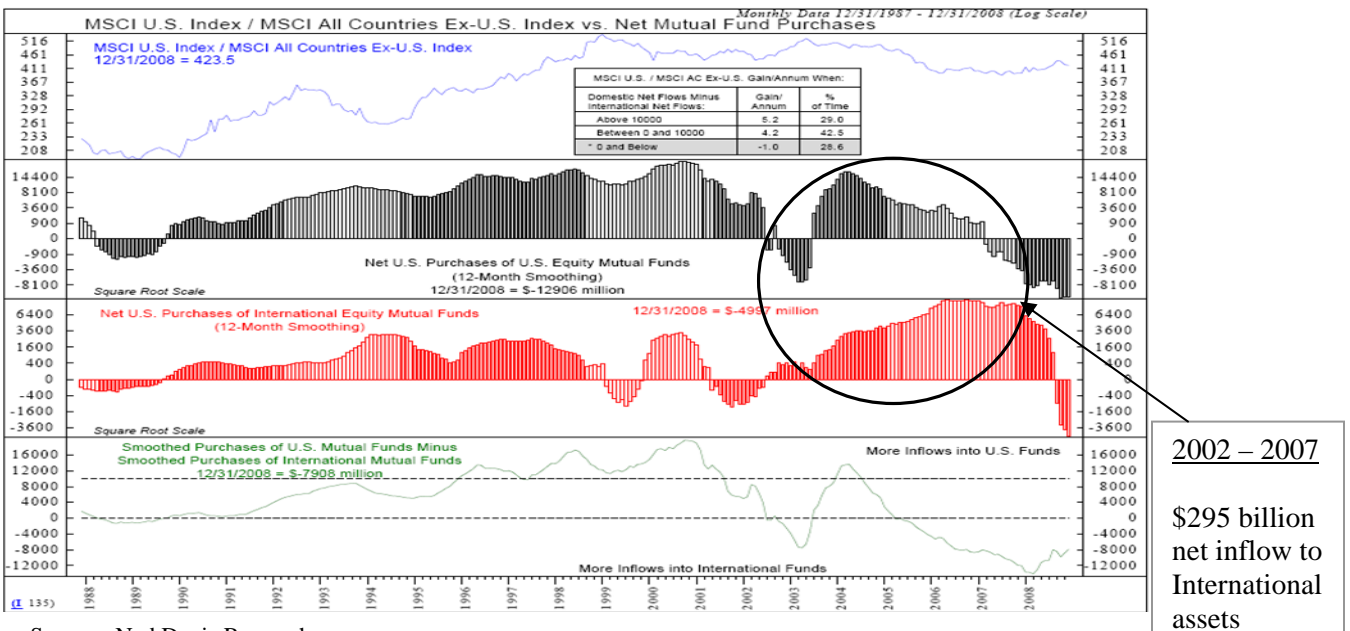
Unlike 1997, the coming change in asset class performance is much broader in scope than simply small versus large cap stocks. We are exiting a period dominated by alternative asset allocation strategies, particularly leveraged asset products, international assets and commodities. Investors flocked to leveraged asset strategies for the promise of high returns and low volatility and to international assets and commodities for the promise of the same as well as portfolio diversification. As the period came to an end, investors were left with unfulfilled promises of low volatility and diversification. Investors are now forced to once again search for new investment alternatives which we firmly believe will be U.S. growth stocks. In this paper we will:

1. Identify the environment after the US Stock Market bubble and the subsequent demand created for alternative investments.
2. Discuss leveraged asset strategies, international investments and commodities as the primary alternative asset classes chosen by investors and how the hopes of high returns, low volatility, and asset diversification created massive inflows into each class.
3. Show the effect these alternative asset allocation strategies had on potential Veredus investment returns relative to other investment periods.
4. Determine what changed to cause the bubble to burst on these alternative asset strategies.
5. Identify where the market is now and determine the asset style and investment characteristics investors will demand in the future.
6. Explain why the Veredus investment process is best suited to benefit from market changes in the future.

We believe the investment world is about to change and investors are going back to basics by demanding transparency, liquidity and consistent earnings growth from their investments. As investors reallocate to U.S. growth stocks, the Veredus investment process is poised to lead all other investment styles.

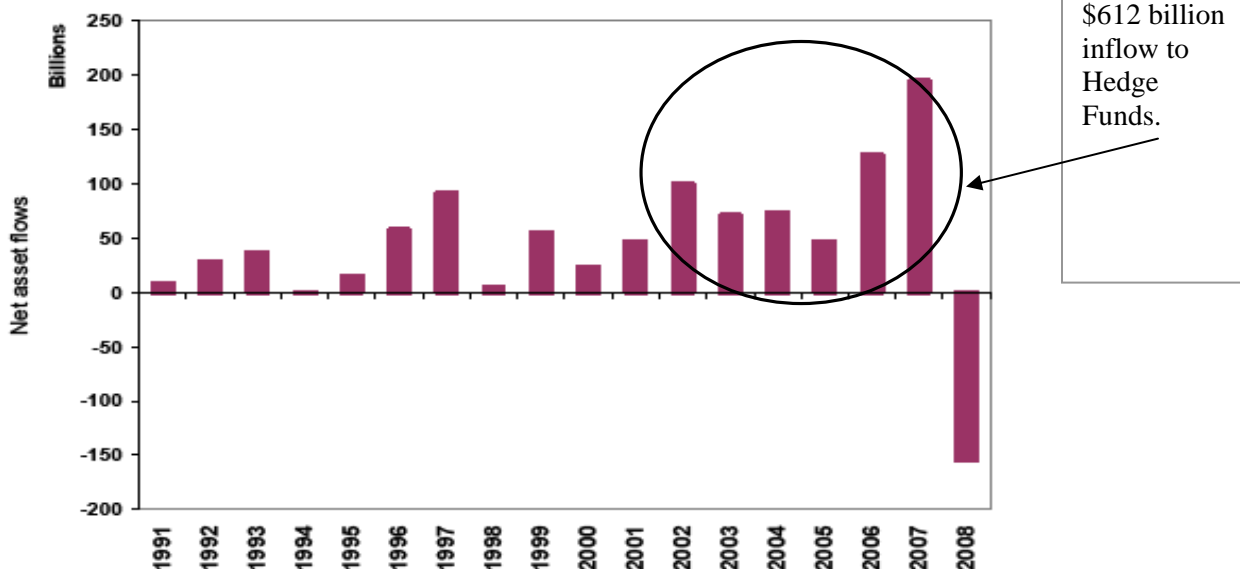
## Recent Past: Market Capital Allocation to Alternative Asset Classes

After the US stock market bubble burst in 2000, US equity values recorded the first consecutive three-year down period since the early 1930s. Even large cap companies, which had not experienced extreme volatility since the early 1970s, saw their value decline significantly. As a result, investors spurned volatility and became highly focused on alternative ways to generate alpha. Thus, investors had a new goal – find new asset classes to lower the volatility and diversify the risk in their portfolios while generating alpha. Wall Street responded with alternative asset classes, including leveraged assets that promised to lower portfolio volatility while producing superior returns and international assets and commodities for diversification. These promises of lower volatility and hopes of diversification drove the money flow out of US equities and into the alternative assets shown in the charts below.



Source: Ned Davis Research

## HFR annual hedge fund net asset flows (1991-2008)



Source: Banc of America Securities-Merrill Lynch Market Analysis, HFR Industry Reports © HFR, Inc.

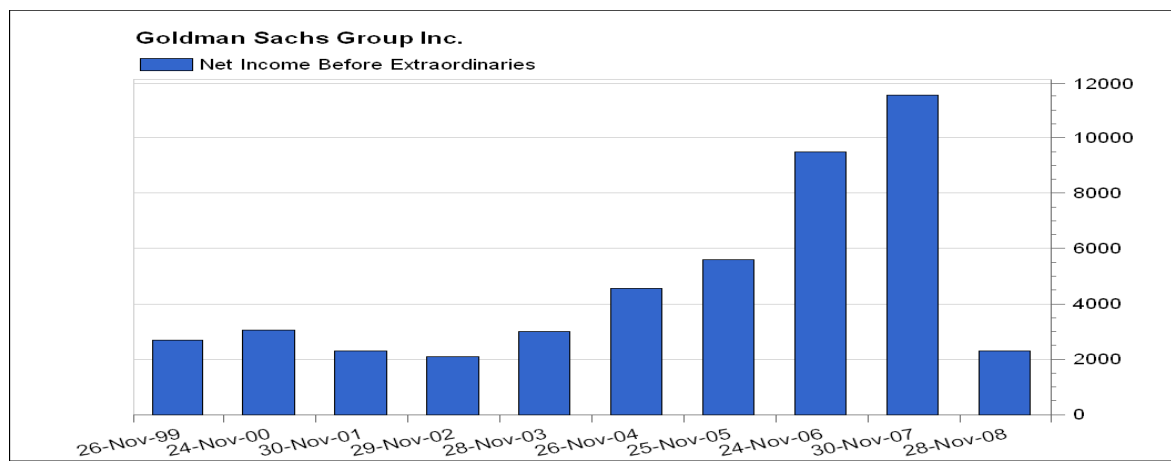
## Alternative Asset Classes: Leveraged Assets, International Assets, and Commodities

### **Leveraged Assets**

The pinnacle of the leverage trade was in 2006 after several years of very low interest rates. The availability of cheap credit encouraged Wall Street investment banks, private equity firms and hedge funds to create a myriad of new strategies employing leverage. Such strategies used credit default swaps, mortgage backed securities, asset backed commercial paper, and off balance sheet special investment vehicles. These strategies quickly permeated the investment community and significant asset allocations soon followed.

### Investment Banks

During the 1990s, investment banks typically leveraged their balances sheet 10 to 1 in an effort to generate returns. Following 2002, the ratio increased threefold to approximately 30 to 1. Goldman Sachs' historical net income had been relatively stable at approximately \$2 billion prior to 2004 as illustrated in the chart below. By 2007, Goldman Sachs Net Income ballooned to \$12 billion, primarily as a result of the increased leverage ratio. Traditionally, investors identify an increase in the leverage ratio by examining the company balance sheet; however, these investment banks used off balance sheet special investment vehicles to house much of their leverage exposure. This lack of transparency kept most investors in the dark until it was too late and led to the demise of historic institutions like Bear Stearns and Lehman Brothers.



Source: Factset

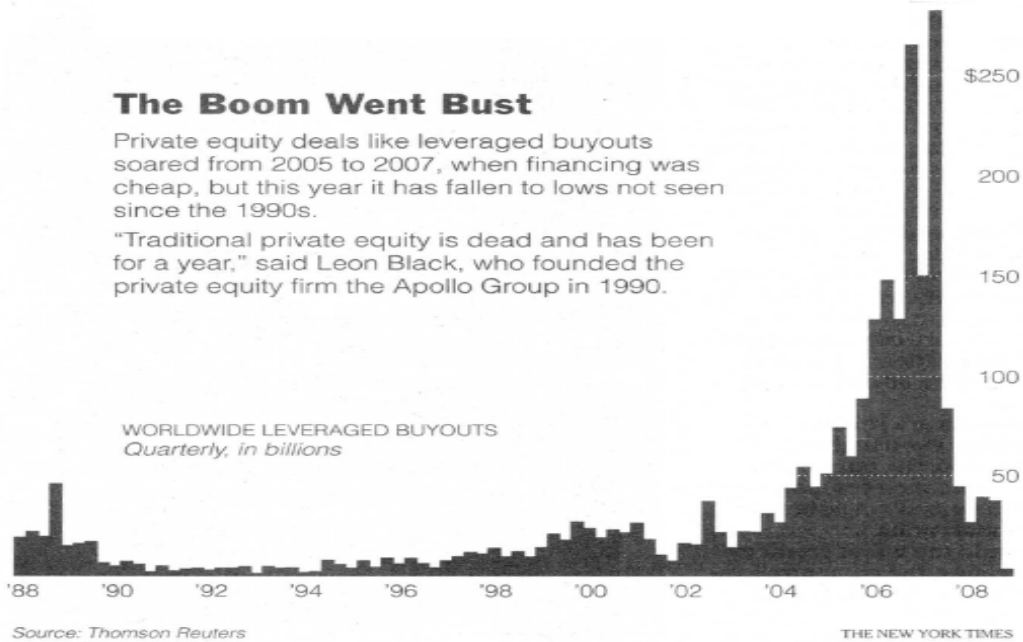
### Private Equity

Private equity, using leveraged buyouts (LBO), was a large asset class in the late 1980s. Michael Milliken of Drexel Burnham supplied an abundance of capital for LBOs, via the junk bond market. The environment produced deals like R.J. Reynolds, which at the time was the largest LBO ever. The LBO era came to an abrupt end just before the 1990 recession with the failure of the United Airlines deal in October of 1989. The recession produced one of the largest banking crises since the 1930s and forced the use of leverage into remission until 2003. Low interest rates and cheap credit jumpstarted the recent private equity boom as investors sought new investment alternatives. The boom peaked in 2006 as massive amounts of cash poured into the asset class. However, the boom waned from 2006 to 2008 as the relative performance of invested capital deteriorated and the subprime crisis triggered a series of events that evaporated cheap credit. By the end of 2008, the private equity boom officially ended. The following chart published by the New York Times in December 2008 illustrates these events.

### The Boom Went Bust

Private equity deals like leveraged buyouts soared from 2005 to 2007, when financing was cheap, but this year it has fallen to lows not seen since the 1990s.

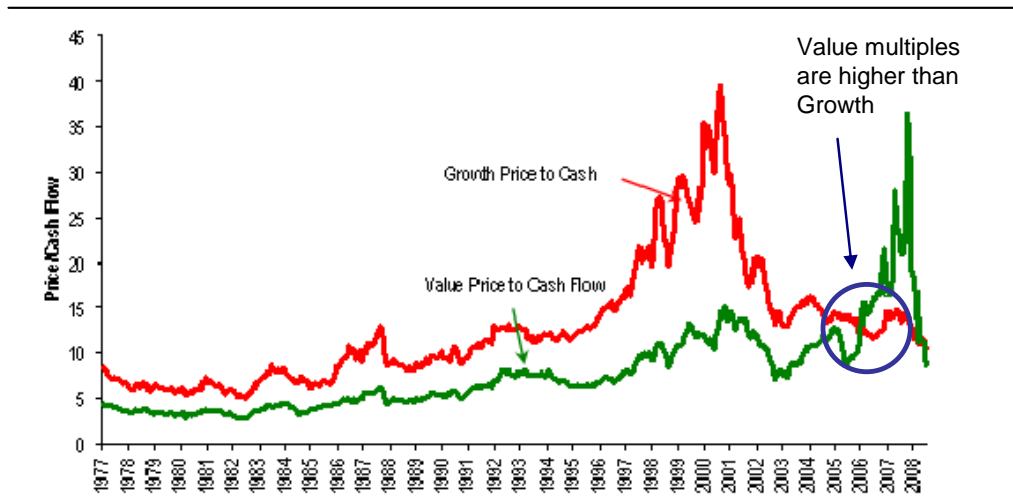
"Traditional private equity is dead and has been for a year," said Leon Black, who founded the private equity firm the Apollo Group in 1990.



\$1.48 trillion inflows between 2002 - 2007

The private equity boom primarily affected stock valuations. Unprecedented capital inflows increased the competition for potential investments. The announcement of one acquisition fueled rumors of another, resulting in the potential LBO of every value stock in the market. Value stocks had outperformed growth stocks, not because of earnings growth, but because of the leverage fueled frenzy. The chart below depicts the average cash flow valuation of growth and value stocks from 1977 to 2008. The valuation spread between growth and value stocks was constant until the bull market from 1996 to 2000. After the bubble burst in 2001, the valuation of growth stocks collapsed while the valuation of value stocks increased. By 2006, the valuation spread between growth and value stocks inverted for the first time since 1977 and coincided with the peak in private equity cash inflows. We believe that after 10 years of extreme valuation fluctuations, cash flow valuation spreads will revert back to the normalized levels of prior decades. This will directly benefit growth stock investing in the United States and the Veredus process.

**Price-to-Cash Flow (Large-Cap Growth versus Large-Cap Value)**  
 (S & P 500 Growth and Value. 1977 to 2008)



Source: Credit Suisse Quantitative Equity Research

### Hedge Funds

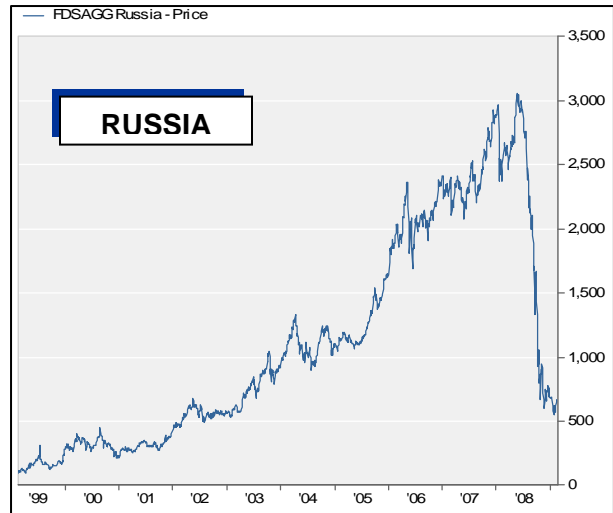
The financial markets have witnessed a dramatic expansion in Hedge Funds over the past decade. From 1998 to 2008, hedge funds expanded from 2000 to 7000 managers and related assets increased from \$600 billion to \$1.5 trillion. Historically, hedge funds were considered market liquidity providers; however, the large increase in fund assets forced them to demand liquidity from the market. The massive increase in hedge fund assets decreased the number of products hedge funds could engage as most employ large amounts of leverage. By 2003, only a few markets were large enough and liquid enough to satisfy hedge fund needs, one of which was the mortgage back securities market (MBS).

The MBS market provided the perfect vehicle for hedge fund investment. In 2003, Federal Agency debt (Fannie Mae and Freddie Mac) and the MBS market combined to total more than \$9 trillion. The size of this market, inflated credit ratings and the secular declines in interest rates all allowed hedge funds to invest massive amounts of capital. Hedge funds quickly discovered they could lever their assets multiple times over and produce huge returns with little volatility and risk. Hedge funds would borrow 10 times their capital bases and buy mortgage pools yielding 5% which produced 50% returns before funding costs. Investors fled the 8% long term returns of the equity market for the promise of outsized returns and low volatility. This demand from investors, in addition to the systematic breakdown of the credit rating and consumer protection agencies, drove record cash inflows into the strategy. But like any strategy, it eventually came to an end.

What investors didn't know was that for the strategy to work it required falling interest rates and perpetually stable or increasing real estate values. By 2007, interest rates started to decline at a slower pace and real estate market values fell as cheap credit evaporated and incremental buyers disappeared. In mid 2008, it became apparent that large mortgage defaults loomed and the hedge funds were forced to unwind their massive leveraged investment positions. A great majority of these investor pools were in illiquid instruments that forced investors to sell not what they should, but what they could – stocks.

### **International Assets**

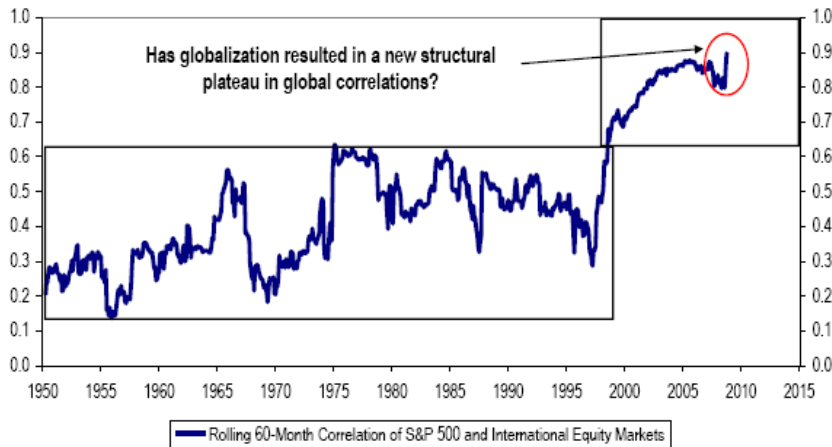
In 2002, international investments accounted for only 6% of world equity allocations. Given the weakness in US stocks after 2000, international allocations were poised to increase. Over the next six years, the international market was responsible for 25% of global GDP growth and investors flocked to the asset class. By 2008, international assets grew five fold to account for over 26% of the world equity asset allocation according to ICI. Over that time period, the Brazilian, Russian, Indian, and Chinese Index values (BRIC) collectively increased by an average of 655%. While these regions did experience well above average growth during the 2003-08 periods and some significant level of appreciation was undoubtedly justified, it is also indisputable that euphoric investor allocations into these regions was a major driver of parabolic asset returns as you can see from the charts on the following page. The subsequent collapse of these indices, in conjunction with considerable cash outflows, further supports the argument. Early on, international assets did provide investors with diversification away from U.S. markets, or so they thought.



Source: Factset

International assets were supposed to provide diversification and growth opportunities for investors away from the U.S. stock market. Initially, investors were rewarded with an asset class with low correlations to the U.S. market. Unfortunately, the international revenue contribution of large multinational U.S. companies grew as international markets grew. Additionally, the heavy manufacturing growth in the international markets increased the dependence on the U.S. consumer. Starting in 2000, these two factors ultimately caused the diversification benefits of international assets to break down and by 2008 international assets were almost 90% correlated to the U.S. stock market (see chart on next page). The diversification benefits were eliminated and once again investors were forced to look for new assets to diversify their portfolios.

## Global Equity Correlations Are Likely To Remain Elevated



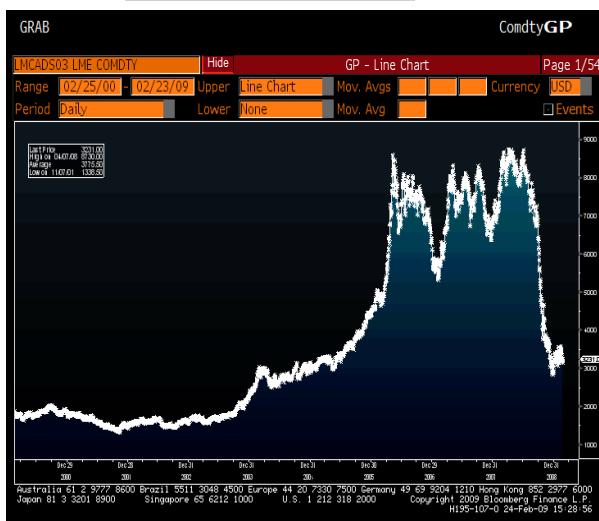
The recent increase in return correlations is just the latest move in a long-term uptrend.

Source: ISI Portfolio Strategy.

## Commodities

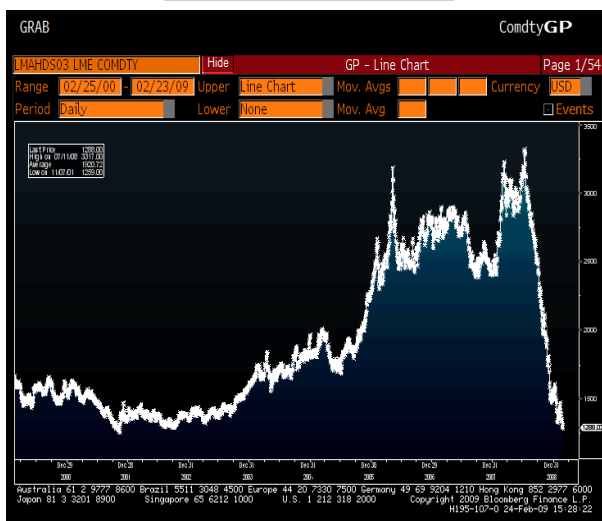
As investors focused their attention on growth investment opportunities in international markets, they bid up the price of commodities needed for infrastructure projects. Projects included roads, water and sewage facilities, electric generation, housing, commercial real estate, manufacturing plants, chemical plants, refineries, oil and gas processing, mining developments and many more. The availability of cheap credit was out of control during this period and few projects were turned down. The incremental demand for hard commodities created by the aforementioned projects outpaced the incremental available supply worldwide. Prices rose dramatically in steel, copper, aluminum, nickel, zinc, and other hard commodities. A chart of copper and aluminum is shown below and is representative of most other metals during this period.

### Copper



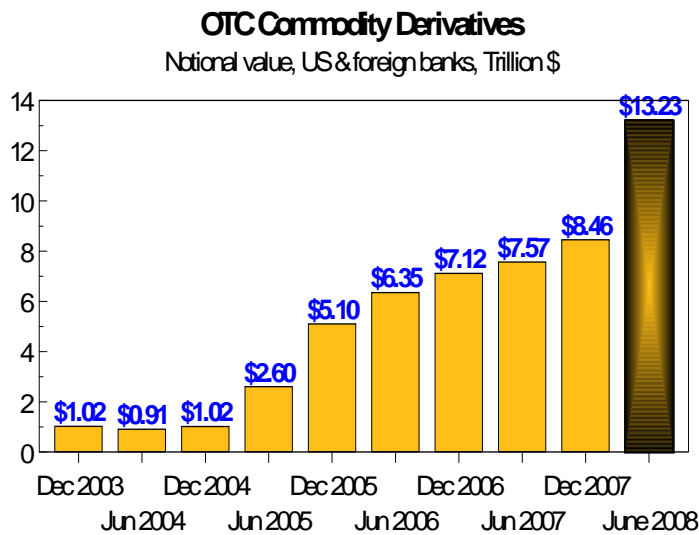
Source: Bloomberg

### Aluminum



Source: Bloomberg

In addition to hard commodities, the energy needs of the emerging markets were ramping as well. Indian oil consumption went up 13% from 2002 to 2003 and China saw an 18% increase from 2003 to 2004 after 10 years of single digit increases in both countries. This energy demand increase was being seen across all the emerging markets and across all the energy sources. This caused the cost of oil, gas and coal to rise rapidly. While there is debate about whether speculation was involved in driving oil to the highs that we saw in 2008, there is no debating that the amount of derivatives used in the commodity market mushroomed during this period. The first chart below shows the growth from an average of \$1 trillion in commodity derivatives to \$13 trillion from 2004 to 2008. The second chart below shows the rapid rise in oil and subsequent rapid decline.



Source: ISI



Source: Bloomberg

With the rapid rise in hard commodities, energy commodities and the perceived growth of the emerging markets, investor money began to pour into soft commodities. The belief was that the increase in per capita income in these emerging markets would lead to a rising demand for increased quantity and quality of food. Prices of wheat, soybeans, corn, and proteins all rose rapidly. As with the other commodities, the incremental demand was more than the incremental supply at the time, but the skyrocketing prices were not sustainable. Charts of Wheat and Soybeans are shown below with their rapid rise and subsequent fall.



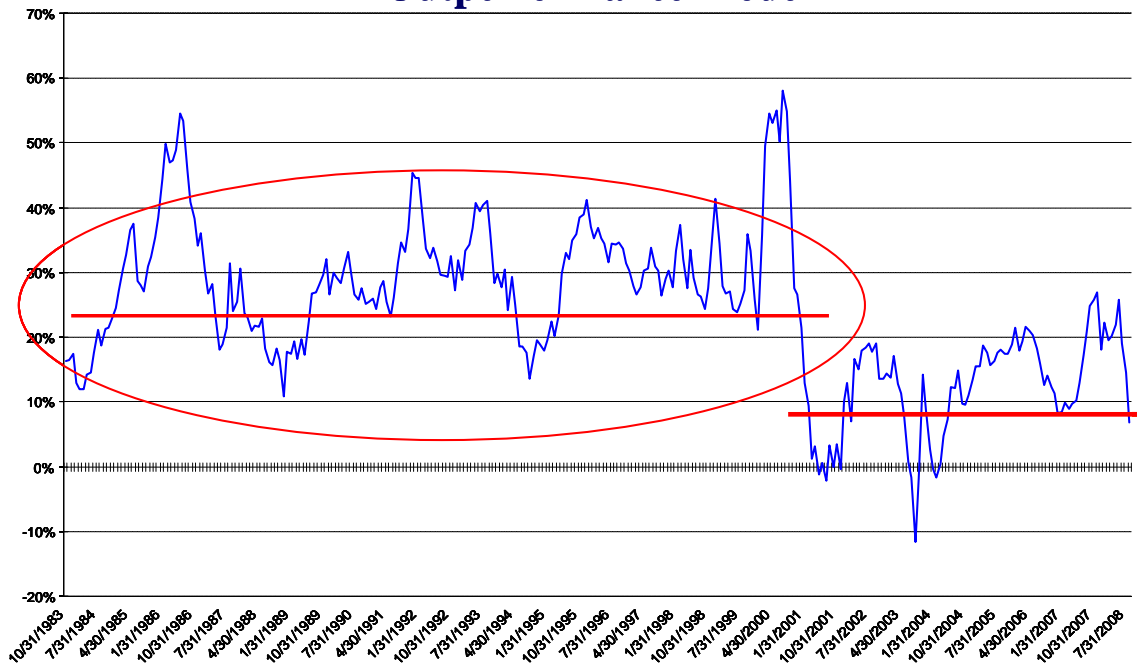
Source: Factset



## Alternative Asset classes and the effect on the Veredus Investment Style

Since 2002, allocations to leveraged, international and commodity assets have negatively affected the Veredus investment style. The valuation of low earnings quality companies was artificially increased by the massive cash flows into the private equity market. Next, the valuations of high earnings quality companies were reduced as investors sold those companies to chase returns in leveraged investment bank and hedge fund strategies, international assets and commodities. The resulting negative impact to the Veredus Investment style is graphically depicted in the chart of the Veredus ERM Top Quintile Outperformance Model on the chart below. The chart represents the potential alpha of the Veredus investment process. Our model tracks the top quintile of companies showing the greatest positive earnings revision of Wall Street estimates and the potential returns of those stocks. From 2001 through 2008, the potential alpha was half of the previous eighteen year period. We will explore the impact of the private equity effect and cash outflows into alternative assets on potential Veredus investment returns.

### Veredus ERM Top Quintile Outperformance Model



Source: VAM

*Potential alpha is cut in half*

### The Private Equity Effect

Private equity firms artificially raised the stock values of companies with poor earnings profiles through LBO transactions. These transactions involved lower quality companies with earnings revisions in the 70<sup>th</sup>-100<sup>th</sup> percentile and were captured in the bottom quintile of the Veredus investment process. Investors no longer rewarded companies for exhibiting positive earnings revision; rather, they diverted their cash flows to underperforming companies in the hopes that such returns created by the LBO phenomenon would continue. The effect was higher valuations for companies outside the Veredus investment process. Additionally, fewer investor dollars flowed into high quality companies and limited potential Veredus investment returns. The private equity effect, which peaked in 2006, is highlighted by the following points.

#### **2006 – The Year of the LBO**

**8 of 10 of the largest LBOs in history closed  
654 companies purchased for \$375 billion - 13 times the 2003 level**

Examples:

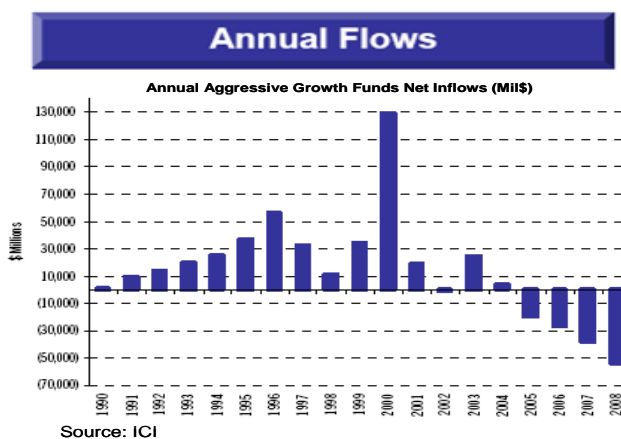
- Linens ‘N Things – 90<sup>th</sup> percentile of the universe - 15% premium, now bankrupt
- Sallie Mae Loan corporation, - 80<sup>th</sup> percentile - 30% premium, deal failed
- Harrah’s Entertainment, - 80<sup>th</sup> percentile - 10% premium, buyer subsequently wrote down investment by 75%.

Other LBO strategies in the bottom quintile of earnings revision which terminated or went to litigation:

- Clear Channel Communications
- BCE Corp
- Reddy Ice Holding
- United Rentals
- Alliance Data Systems

### Cash Out Flows into Alternative Investments

Investors reduced their exposure to the U.S. equity markets as they chased leveraged strategies from investment banks and hedge funds for the promise of high returns and low asset volatility. Investors also chased international assets and commodities for high returns and asset diversification. The reallocation process pressured equity prices as investors sold stocks with the premium valuations. These premium names were typically companies that produced consistent earnings growth and were the focus of the Veredus investment process. As a result, stocks in the top quintile of the Veredus investment process did not produce the same potential returns as they did from 1983-2002. Below is a chart of investor cash flows out of domestic and aggressive growth equities.



## Why the Alternative Asset Class Bubble Burst in 2008

As the leverage asset market peaked in 2006, many analysts and investors began to worry about the quality of incremental real estate loans. Exotic real estate loan products featuring interest only payments and low introductory teaser rates opened the real estate market to unqualified buyers that were previously unable to purchase a home. The number of variable interest rate loans increased drastically and U.S. real estate values were driven to all time highs as purchase demand surged. Fears of inflation drove the 10 year Treasury bond yields above 6%; it became clear to the market that the massive wave of variable mortgage notes would be forced to reset at significantly higher levels. The real estate bubble came to an end when the market figured out that a large number of borrowers wouldn't be able to afford their mortgages. Financial markets began to discount massive mortgage defaults in mid 2008 and credit costs exploded as evidenced by High Yield Credit spreads in the graphic below.

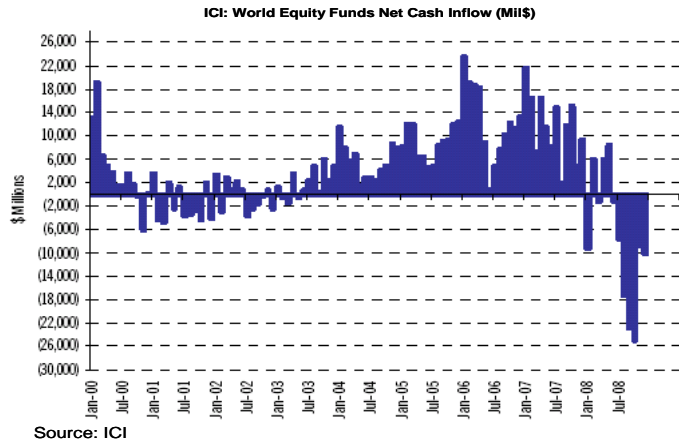


Source: Bloomberg

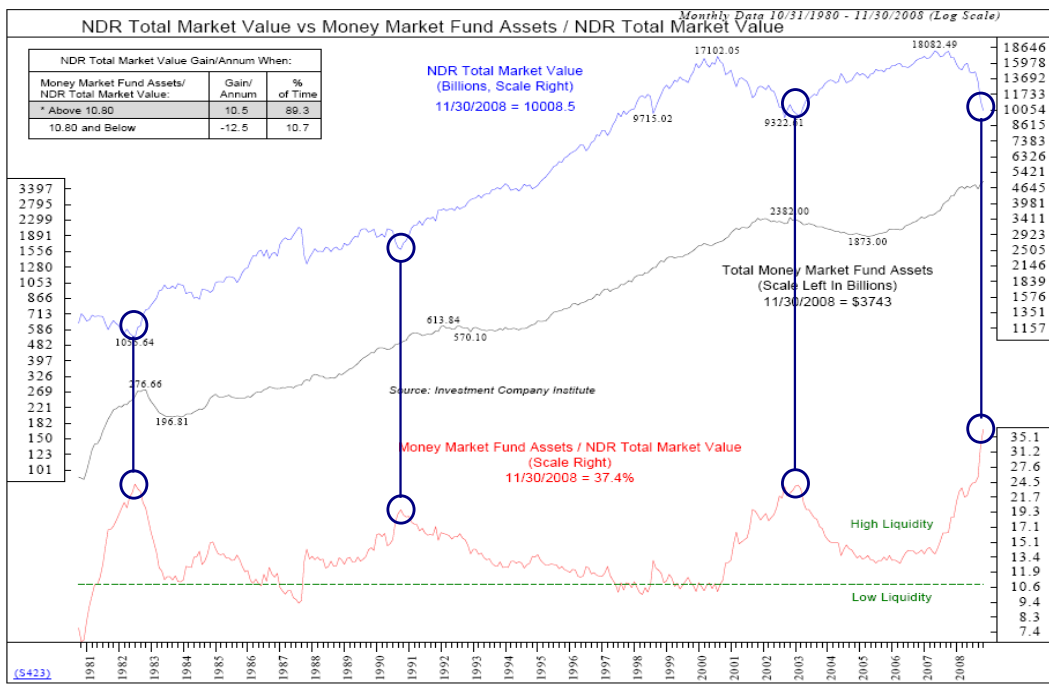
Increasing credit costs not only affected the mortgage market but also ended the private equity boom. Even though potential returns in private equity were declining, robust demand from investors continued to drive the asset class into mid 2008. But when credit costs spiked, business models were no longer able to provide typical private equity returns. Borrowing costs peaked and the demand for private equity as an asset class dried up.

Lastly, the weakening credit markets hit the international and commodity markets. The urbanization of Asia and the rebuilding of Eastern Europe attracted significant investment capital to the regions. Capital projects were funded primarily from the credit markets and produced virtually all of the incremental global demand for commodities. Like the other Alternative Asset classes, the international and commodity boom ended when the availability of cheap credit vanished. Furthermore, investors exited the asset classes in droves as the diversification benefits they originally sought evaporated, as illustrated in the following chart.

# Monthly Flows



Once again investors were fooled by promises of high returns, low volatility, and asset diversification. By the end of 2008, investors stuffed record amounts of cash into money market funds and treasury bonds looking for a safe haven away from market volatility. In the chart below, the peaks in money market fund assets historically coincide with troughs in the stock market and are followed by periods of stock market gains. We believe investors are about to go back to basics and demand three things from their investments: transparency, liquidity and consistent earning growth.



Source: Ned Davis Research

10 Year Bond Yield - Weekly



Source: VAM

As the chart above illustrates, ten year treasury yields are at levels not seen in over 65 years and are now back to yields that haven't been seen since the 1930s. At some point, a simple reallocation from fixed income back into equities will have to take place as endowments and plan sponsors grapple with how to get back to a funding equilibrium.

### **The next step for Investors – Reallocation to U.S. Equities**

The allocation to money market funds and treasury bonds indicates investors are currently highly risk averse. False promises from Wall Street of high returns, low volatility, and diversification have left investors wary of all investment classes. Money market fund balances are at all time highs as investors regroup. We expect investors to go back to basics. Investors will demand transparency, liquidity and consistent earnings growth from their investments. Investors will seek managers with attractive investment styles poised to outperform in the coming environment.

Money market fund assets are at record levels. Per the second chart on page 12 from Ned Davis Research, there is over \$3.5 trillion in money market mutual funds. These high cash levels represent 35% of the value of all domestic equity mutual funds combined. Comparably, after the 2000 bubble, cash balances reached only 25%. High current cash balances are indicative of only one thing – investors are searching for new investment alternatives.

Investors will no longer tolerate complicated investment structures they don't understand. The failure of financial products such as Credit Default Swaps and Mortgage Backed Securities will drive investors to seek transparency and search for assets they can understand. Investors will also demand liquidity. Hedge funds often feature minimum lock up periods and private equity investments require long time horizons to realize returns. In the recent market environment, investors lost significant capital waiting to redeem their money from hedge funds as markets plummeted. Hedge funds were forced to sell U.S. equities to satisfy investor redemptions which further pressured U.S. equity prices. Investors, locked into long term private equity investments, faced capital calls which many satisfied by selling their only liquid assets, U.S. equities. These events are forcing investors to demand liquidity and control over their investment dollars. Since the U.S. stock market is the most transparent and liquid in the world, we believe investors will reallocate back to the U.S. market, as it was the first to experience the credit crisis and the first to address the financial turmoil. Lastly, investors will demand investments offering consistent earnings growth. Companies with consistent earnings growth create wealth and we believe investors will award these assets a premium valuation. Investors are going back to the old days when they invested in fund managers with a proven track record and a process that focuses on these criteria.

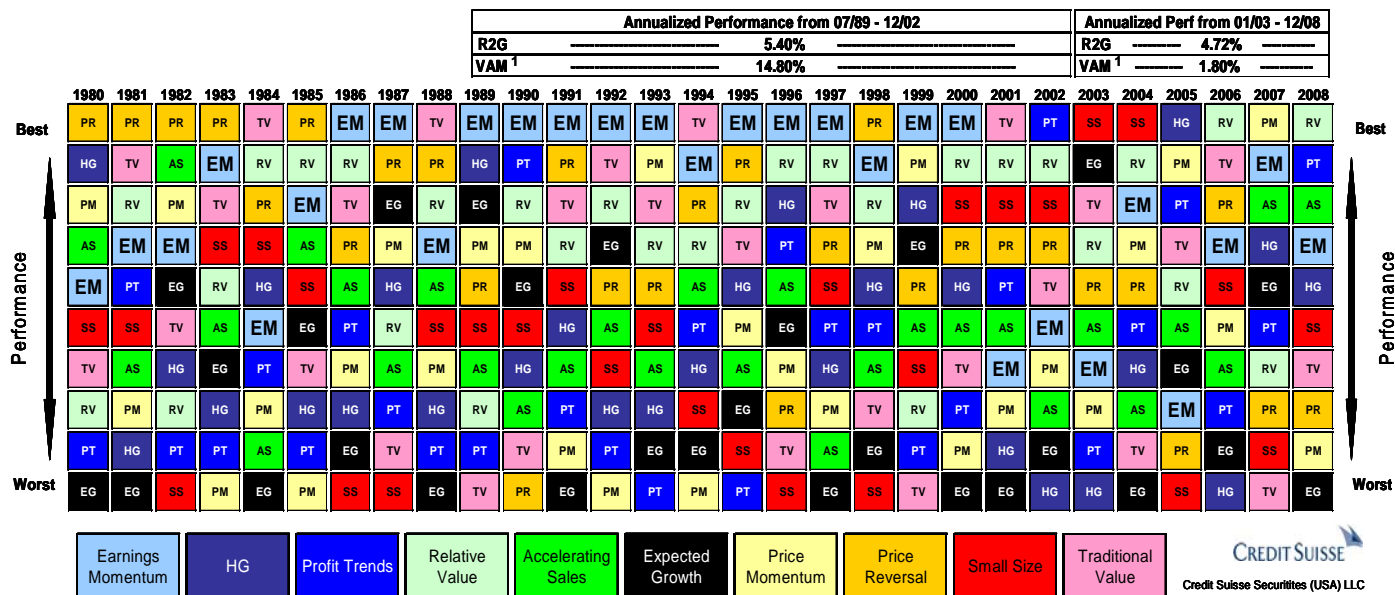
### **Why the Veredus Asset Management Investment Style will win**

The Veredus investment process focuses on the top 20% of companies with the highest earnings revision relative to the entire universe of stocks. Historically, companies that consistently meet our process criteria generate earnings growth over long periods of time and create wealth. Additionally, these companies tend to have high barriers to entry, are experiencing positive secular trends in their markets, have the ability to expand margins and take additional market share. Cheap credit is no longer increasing the value of underperforming companies and the secular growth of the U.S. economy is slowing. As a result, we believe the market will pay a premium for companies meeting our process criteria. The scarcity value of these companies, along with the decline in secular growth, will push the overall return characteristics of our process not just back to the mean, but potentially above the long term average. We believe this trend began in 2007, as our performance numbers revealed, but was derailed by the credit crisis in 2008. As the clouds from the credit storm dissipate, we are confident our process will find itself at the top of the overall performance rankings like many years in the past.

The chart on the following page is an analysis by Pankaj Patel from Credit Suisse identifying ten different investment styles and showing the performance of each equity investment style dating back to 1980. The Veredus investment process is captured by the Earnings Momentum (EM) classification in the analysis. EM placed in the top three investment styles 16 of 20 times from 1983-2002 and was the top performing investment style in 12 of those occurrences. Conversely, from 2003 to 2008, EM only placed in the top three in 2004 and 2007, which were our two best relative years in that six year period. Below we have included both the complete Credit Suisse analysis and a line chart isolating only the yearly rank of the EM investment style. The line chart clearly shows a correlation between the Credit Suisse analysis and the Veredus ERM Top Quintile Outperformance Model. Furthermore, we have included actual Veredus and Russell 2000 Growth returns to clearly identify the relationship between our actual returns and the overall market environment. We believe these examples clearly link our process to historical style returns and indicate that our process should return to the top of all investment style returns.

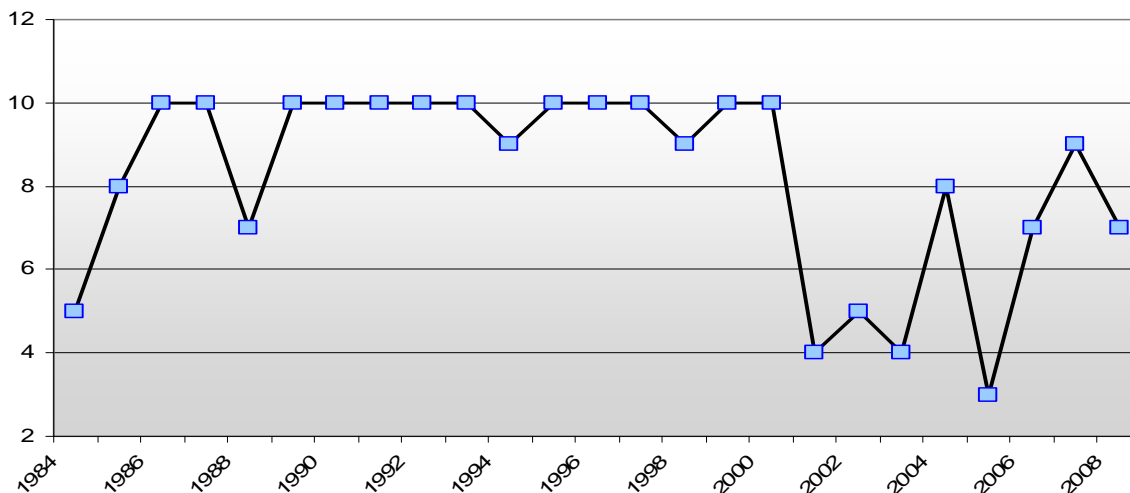
# Earnings Momentum from 1983 – 2002

## 16 of 20 years in the 1<sup>st</sup>, 2<sup>nd</sup> or 3<sup>rd</sup> decile



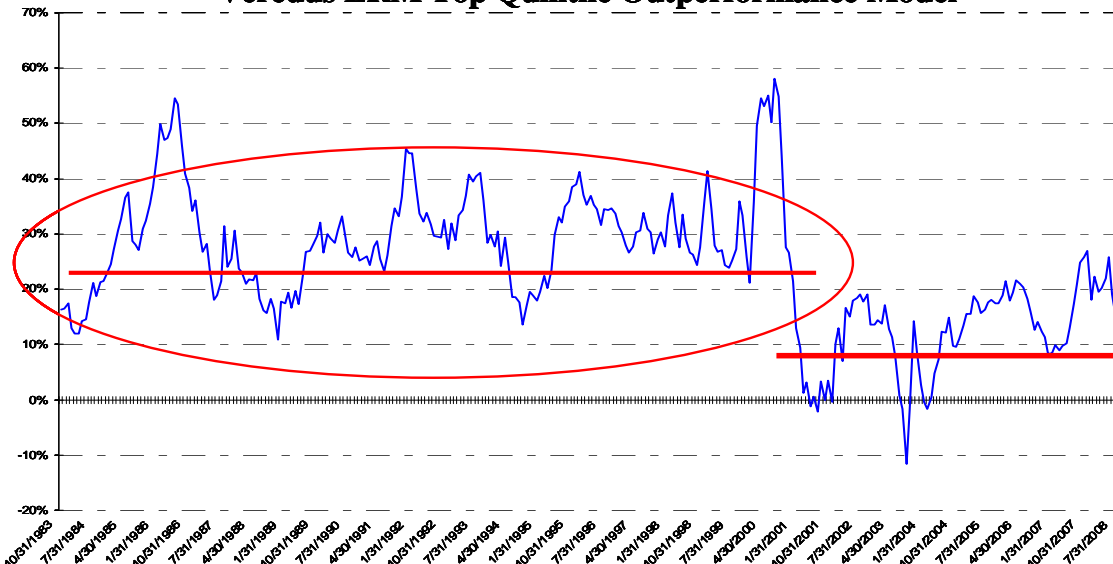
The format of this chart has been modified to adapt to Veredus presentation style. Refer to Credit Suisse Alpha Definitions at the end of this report.

### Relative Return Ranking EM Investment Style - Credit Suisse



Source: VAM

### Veredus ERM Top Quintile Outperformance Model



## **Conclusion**

We believe investors are poised to return to U.S. growth stocks. Now that the credit, international, and commodity bubbles have burst, we believe investors are seeking new investment opportunities. After 10 years of unfulfilled promises and one of the worst compound returns in the history of the U.S. equity markets, investors are going back to basics. Investors have poured record amounts of cash into safe havens such as money market funds and U.S. Treasury bonds as they evaluate their next move. We believe investors will seek investments that provide transparency, liquidity and consistent earnings growth. Transparency will come from companies with understandable business models. Investors will seek liquidity by returning to the U.S. equity market, which is the largest and most liquid in the world. Investors will seek consistent earnings growth from U.S. growth stocks that have produced these characteristics in the past and can potentially produce them in the future. We believe investments with these characteristics are scarce and the investment community will award these investments with a premium valuation. These potential investments are the foundation of the Veredus investment process and should push our potential returns back to historical highs. We believe the market is on the cusp of these events and we firmly believe the Veredus investment style could return to the top of the investment world as we experienced throughout the 1990s.

While I would like to take credit for this paper, I cannot, as it was a collaboration among our entire Investment Team. I have listed the members below.

B. Anthony Weber  
President & Chief Investment Officer

Charlie F. Mercer, CFA  
Executive Vice President & Portfolio Manager

Michael E. Johnson, CFA  
Vice President & Portfolio Manager

John Prys, CFA, CPA  
Director of Research

Katherine Kuntz, CFA, CPA  
Research Analyst

Kevin Maynard, CFA  
Research Analyst

The matters discussed in this paper may constitute forward-looking statements made pursuant to the safe harbor provisions of the Securities Litigation Reform Act of 1995. These include any prediction, assessment, analysis or outlook for industries, investment styles, market sectors and/or markets.. The accuracy of the our predictions, the appropriateness of the investment strategies designed by Veredus, and our ability to implement the strategies efficiently and successfully could affect future performance. Past performance is no guarantee of future results, and there is no guarantee that the forecasts discussed in this paper will be realized.

**<sup>1</sup>Past performance does not provide any guarantee of future performance, and one should not rely on the composite performance as an indication of future performance. Investment return and principal value of an investment will fluctuate so that the value of the account may be worth more or less than the original invested cost. In 1999, the performance of the composite was in large part attributable to the investment in technology holdings. Investors should realize that favorable conditions for technology stocks may not be repeated in the future.**

Veredus Asset Management LLC (“VAM” or “the Company”) is a registered investment adviser formed in June 1998. The performance presented represents a composite of corporate retirement accounts, foundations, municipalities, IRA’s, and mutual funds, invested primarily in small cap domestic equity securities with the objective to seek capital appreciation. This goal is pursued by investing in a diversified portfolio of equity securities, including relatively new or unseasoned securities, that VAM believes are likely to achieve superior growth in earnings. This growth is typically generated by increasing unit volume and expanding margins derived from developing new products, services and markets. This investment strategy is more aggressive and could result in higher volatility than other investment strategies.

Upon formation, VAM had several corporate retirement accounts assigned to it from SMC Capital, Inc. (“SMC”). Prior to the formation of VAM, the principals of the company were primarily responsible for the management of the corporate accounts, as well as a mutual fund for SMC and related entities from July 1, 1989 to May 29, 1998. Mr. Weber, who is the President and Chief Investment Officer of VAM, served as the President and Senior Portfolio Manager of SMC. Prior to the formation of SMC, Mr. Weber managed three common trust funds for Shelby County Trust Bank. The investment objectives, policies and strategies for SMC are substantially similar to those of VAM. SMC has provided written authorization allowing VAM use of the performance history for this report.

As of December 31, 2008, VAM provided investment management services for accounts totaling approximately \$450 million in assets. This composite represents all eligible accounts managed using the strategy described above. The composite excludes accounts that are sector specific accounts, focused on stocks with larger capitalization accounts, managed to minimize income taxes, and hedge funds. Accounts are eligible for inclusion in the composite at the beginning of the first calendar quarter after the month of initial funding. Closed accounts are included in the composite through the completion of the last full month under management, and the historical information on the account remains part of the composite.

The performance information is presented on a trade date basis, net of management fees (except when noted) and transaction costs. Performance is computed on a time-weighted rate of return with dividends and interest being reinvested. All cash reserves and equivalents have been included in the calculations. The composite return is asset weighted and linked together to calculate returns for extended periods.

The composite performance has been compared to the following benchmarks (all shown with dividends reinvested): Russell 2000 Growth – Unmanaged index that contains common stocks, from the Russell 2000, with higher price-to-book ratios and higher forecasted growth values.

# Alpha Definitions

## Value

### Traditional Value

▪The Traditional Value alpha portfolio buys cheap stocks and shorts expensive ones. We measure value using price ratios such as price to earnings, price to book, price to cash flow and price to sales. We refer to this approach as traditional value because these ratios have long served as the traditional measures of value.

### Relative Value

▪For Relative Value alpha, we measure value using industry relative price ratios such as price to earnings, price to book, and price to sales. In this approach, a stock is considered cheap if its ratio is less than the industry average. We also look at the same measures across time. We consider a stock cheap if the current spread between its ratio and the industry average is less than the historical average spread. We look back five years.

## Growth

### Historical Growth

▪The Historical Growth alpha portfolio buys stocks with strong records of growth and shorts those with flat or negative growth rates. We measure growth based on earnings growth rates, revenue trends, and changes in cash flows.

### Expected Growth

▪The Expected Growth alpha portfolio buys stocks with high expected earnings growth rates, and shorts those with low or negative expected growth rates.

## Profitability

### Profit Trends

▪Profit Trends alpha portfolio buys stocks showing strong bottom line improvement and shorts stocks showing deteriorating profits or increasing losses. We measure profit trends by using the following ratios: overhead to sales, earnings to sales and sales to assets. We also use trends in the following ratios: 1) (Receivables + Inventories)/Sales, 2) Cash Flow to Sales and 3) Overhead to Sales

### Accelerating Sales

▪The Accelerating Sales alpha portfolio buys stocks with strong records of sales growth and shorts those with flat or negative sales growth. We measure the rate of increase in sales growth, hence the accelerations of sales.

## Momentum

### Earnings Momentum

▪We define earnings momentum in terms of earnings estimates, not historical earnings. The Earnings Momentum alpha portfolio buys stocks with positive earnings surprises and upward estimate revisions, and shorts those with negative earnings surprises and downward estimate revisions.

### Price Momentum

▪The Price Momentum alpha portfolio buys stocks with high returns over the past 6-12 months, and shorts those with low or negative returns over the last 6-12 months.

## Technical

### Small Size

▪The Small Size alpha portfolio buys the smallest decile stocks in the index and shorts those in the largest decile.

### Price Reversal

▪Price Reversal is the pattern whereby short-term winners often suffer downside reversals and short term losers tend to bounce back to the upside. These reversal patterns are evident from horizons of one day to four weeks.