EMERALD ADVISERS, INC.
2011 1ST QUARTER ECONOMIC & PORTFOLIO COMMENTARY

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REMARKABLE RESILIENCY

1st Quarter 2011	
Russell 2000 Growth	9.2%
Russell 2000	7.9%
S&P 500	5.9%

The summary of the headline stories of 2011 would paint a bleak and disheartening picture of the past three months. The natural disaster in Japan (the aftermath of which the market is still trying to understand) and the surge in oil and gasoline prices driven by the social unrest that swept across more than a dozen countries in the Middle East and North Africa. The situation in Europe has remained volatile, with the collapse of the government in Portugal forcing bond yields up in excess over 400 basis points from early March through early April. At home, while not in a civil war like that which erupted in Libya, a war of sorts is raging regarding the budget and the debt ceiling. Amazingly, in spite of all of these issues and surrounding uncertainty, the market was able to push forward with the S&P 500 posting a 5.9% return, the best start to a year since 1998.

Why the resilience? Underlying economic growth remains encouraging. Fourth quarter earnings reports were broadly better than expected, retail sales have remained strong, job growth has accelerated, albeit rather modestly, and equity inflows have remained positive. Further, merger and acquisition activity remained robust. According to Dealogic, there have been $784.1 billion in total deals announced this year, representing a 23% increase over the same period in 2010. Emerald believes that all of these factors have helped to mute the market impact of the extraordinary series of events discussed above.

Small capitalization stocks, similar to the market overall, proved resilient during the quarter outpacing their large capitalization brethren. The Growth style also remained in favor as the technology, energy and materials sectors continued to outperform the index overall. Further within the Russell it is notable to point out that from an attribution standpoint, the highest price/earnings ratio, highest growth, highest ROE and highest beta quintile showed the largest gains. Performance within the market cap quintiles also favored the larger capitalization stocks within the Russell 2000 index. Contribution from all of these factors, as well as strong stock selection, contributed to the solid outperformance experienced by the Emerald portfolios this quarter. The most notable aspects of quarterly performance are detailed below.

Portfolio Performance

The technology sector was the largest positive contributor to return during the period driven both by the portfolio's overweight position and stock selection. Outperformance remains broad-based with positive variation within the communications, software, and electronics industries. We believe the industrial laser industry represents one of the market's most compelling growth opportunities over the next decade.

As we enter the second quarter of 2011, investor sentiment regarding technology stocks has become more cautious. The uncertainty regarding Japan related supply-chain disruptions, the potential for a pause in enterprise spending and more constrained consumer spending due to rising oil prices have collectively dampened investor enthusiasm for technology stocks. While the market has gotten incrementally more cautious in the near-term, Emerald does not believe there has been any pullback in spending intentions at the corporate level. According to a recent survey by Morgan Stanley, technology spending intentions remain encouraging with 2011 spending expected to grow 4% for the year, representing a sequential increase in intentions. While less quantifiable it was also interesting to note that Chief Information Officers indicated as part of this survey that they were more inclined to spend on growth initiatives, which Emerald views as supportive of the portfolio's overweight position and focus on secular trends such as mobility/wireless infrastructure spending and enterprise spending.

Despite the weak relative performance of the consumer discretionary sector, Emerald was able to outperform due to a positive contribution to return from stock selection within the specialty retail and rental and leasing service industries. Unlike 2010, Emerald believes the outlook for the consumer discretionary sector is less clear. While recent retail sales figures and jobs data are encouraging as it relates to consumer demand, the residual impact of commodity inflation remains a significant source of uncertainty. Elasticity of demand will be a key focus as companies look to pass through a significant portion of the cost increases being experienced in food, materials, labor and transportation by way of price increases to the consumer. Up to this point, early increases have not resulted in any degradation in demand. However, early indications, while encouraging, may not be indicative of consumer response as the rate of increase in price is expected grow in magnitude as the year progresses, creating a greater degree of uncertainty and visibility as it relates to earnings growth for these industries. While the near-term opportunity set in the consumer discretionary sector has narrowed due to the aforementioned concern, opportunities remain and Emerald continues to focus on identifying niche opportunities with attractive growth prospects.

Performance within the energy sector was also a source of positive contribution to return for the quarter. Emerald portfolios outperformed the energy sector of the Russell 2000 Growth index based on strong stock selection in the oil service and exploration and production industries. Emerald maintained its' overweight to oil biased names as well as its emphasis on energy service names benefiting from increasing service intensity. Looking forward we are more than a bit concerned with the price of oil and its impact on the nascent U.S. and international economic recovery. Oil is relatively well supplied worldwide, but the level of the Middle East fear premium in the current price of oil is hard to judge. One thing is certain; the longer oil stays at these high levels the more likely that its deleterious impact on consumers and business will be built into the cost structure ultimately paid by virtually everyone.

Outside of the aforementioned, the portfolio also experienced positive contribution to return within the materials and healthcare sectors driven by stock selection.

Entering the second quarter the portfolio is currently overweight the technology and producer durables sectors; equal-weight the energy sector and underweight the financial services, consumer discretionary, healthcare, materials and consumer staples sectors.

Market Outlook

As we look to the balance of 2011, the wall of worry seems to be building. Some of the more prominent concerns include: inflation, geo-political turmoil, European sovereign debt, the U.S. budget deficit, the end of QE2, dissention in ranks of the Federal Reserve as it relates to the timing of rate increases and the unfolding implications of the Japan tragedy. As a result, market resilience will likely continue to be tested. Despite these concerns, Emerald remains optimistic regarding the outlook for 2011. Our optimism is centered around our positive outlook on corporate profit growth and supported by an encouraging economic backdrop. Further, supporting our optimism is our ongoing expectation for increased merger and acquisition activity. Corporate balance sheets remain flush with cash, and according to a recent report by Credit Suisse, the ratio of liquid assets to total assets on non-financial corporate balance sheets is near a 45 year high. Companies have shown an inclination to acquire, reflecting their desire to grow, versus return capital to shareholders through dividends or buybacks. Valuations on deals completed over the last 12 months have been encouraging and demonstrative of the value that remains in the market place. Additionally, and not insignificantly, equity inflows have remained positive.

That being said, while different factors may alter our outlook and portfolio positioning, Emerald intends to approach the rest of 2011 with the same commitment to its fundamental, bottom-up investment philosophy and process that has been in place since the inception of the firm.

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