EMERALD ADVISERS, INC.
2011 3RD QUARTER ECONOMIC & PORTFOLIO COMMENTARY

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FEAR CAUSES MARKET TO DECLINE

3rd Quarter 2011	
Russell 2000 Growth	-22.2%
Russell 2000	-21.9%
S&P 500	-13.9%

Market correction hits hard in the third quarter, as European sovereign debt worries and the Chinese slowdown and its effects on the US economy causes losses equal to a bear market, at least in small cap land. Given the fact that the decline in the S&P500 was nearly 14% in the 3rd quarter, it is really no surprise that small cap stocks actually suffered a bear market decline of over 20% in the quarter. As we witnessed an extremely high correlation among stocks in the quarter, a record high in the VIX or volatility index, added to the 20% small cap has actually caused us to take a more opportunistic attitude towards the quarter because valuations are facing the worst. We are of the belief that this bad quarter can actually be good for the market going forward. To back up our 'bad is good' comment, we look at the fact that we just recorded the lowest relative performance for the Russell 2000 Index vs. the S&P500 since 1998. Anything short of a double dip and/or negative earnings growth will lead us to higher, if not much higher valuation levels.

Policy uncertainty is undercutting growth. Even with a decline of over 22% in the Russell 2000 Growth Index for the quarter, growth still leads small cap value for the year by almost 3%. If we dissect the year to date performance into the before and after April 29th, we find that small cap growth outperformed by almost 500 basis points and only underperformed slightly since the peak. In fact, no matter the cap size; large, mid, small or micro, growth leads for the year. We believe this is very important as neither the midyear 2010 nor this 2011 correction has interrupted, yet alone ended, the growth cycle that began in the spring of 2009.

We also note that the best performing domestic index of the year has been the Russell 1000 Growth Index. While out of favor for the first 10 years of this century, we believe small capitalization growth stocks are inexpensive on a relative basis and we also believe that the easing of the VIX Index, the market's measurement of fear, will close the gap in performance this year between large and small capitalization stocks. Only the continuation of the VIX Index at such extremes as we had in the 3rd quarter will keep the superior earnings growth rates in the small cap index from being recognized in their valuations.

Portfolio Performance

The market in general remained sanguine through July before beginning its sudden descent one month into the quarter, fueled by the second iteration of the Greek sovereign debt crisis, the US budget crisis, and the end of the Federal Reserve's second round of quantitative easing (QE2).

Emerald modestly underperformed the Russell 2000 Growth Index during the quarter as our overweight positions in the cyclically sensitive Technology and Producer Durables sectors offset stock selection driven outperformance in the Health Care, Consumer Discretionary, and Consumer Staples sectors. Below is a summary of the key portfolio highlights for the third quarter of 2011:

Technology

Emerald maintains its most significant sector overweight position in the Technology sector, largely due to our continued belief in the growth opportunities related to mobility, cloud-based computing, network security, and industrial laser technology. However, in the third quarter the Technology sector came under pressure as macro-economic concerns dampened investor enthusiasm for the sector's near term growth prospects, despite continued company-specific positive developments.

One of our most successful investment themes over the past twelve months has been the growth of the industrial laser market. However, in Q3-11 each of our three industrial laser related holdings declined in value by more than 25% despite continued strong financial performance from the group. We continue to believe that each of our industrial laser related holdings has attractive, long-term, secular growth opportunities. Despite the recent underperformance, we believe the combination of compelling growth prospects, attractive valuations, and modest Wall Street analyst coverage sets the stage for meaningful, long-term investment outperformance. We also believe there is potential for significant merger and acquisition activity within the Technology sector, particularly as economic concerns wane.

Fundamentally, many companies within the Technology sector remain healthy, with compelling growth opportunities, solid margin profiles, strong balance sheets, and manageable levels of inventory. While the current environment appears to have punished the strong companies, as well as the weak, we believe the situation is likely to prove temporary in nature. We continue to believe that secular trends such as mobility/wireless infrastructure build-out and enterprise technology spending, among others, will continue to evolve and that the recent underperformance of the sector has created compelling investment opportunities in leading companies at attractive valuations.

Producer Durables

Emerald realized underperformance in the Producer Durables sector as our stock selection was challenged by macro-economic concerns that challenged the outlook for what has typically been a highly economically sensitive sector. Emerald realized solid investment performance in the areas of transportation, however, these areas were more than offset by underperformance in areas viewed to be more cyclically sensitive.

Energy

Emerald realized modest underperformance in the Energy sector despite maintaining an underweight position throughout the quarter. A significant pull back in key commodity prices, such as WTI oil and NYMEX Natural Gas, which both declined nearly 20%, pressured stocks in the Energy sector, particularly many of the faster growing companies in the sector.

We believe the industry fundamentals do not support a precipitous decline in the energy commodity prices as those experienced during 2008. As a result, we believe the recent pullback in the energy sector offers opportunities to invest in a number of compelling, growth-oriented companies at attractive valuations.

Healthcare

The Healthcare sector was one of the relatively strongest sectors during the third quarter, proving once again to be relatively defensive in nature. Emerald outperformed in the sector, largely due to solid stock selection.

Emerald's strategy in the Healthcare sector remains to be primarily invested in those companies whose growth is driven by products and services that produce savings for the healthcare system, as well as in companies that lack reimbursement concerns.

Consumer Staples

The Consumer Staples sector was the best performing sector in the Russell 2000 universe for the third quarter with a return of -8%, as you might expect given the historically defensive nature of the sector.

Emerald continues to take an offensive approach in what has traditionally been regarded as a defensive sector by positioning the portfolio in the most compelling growth opportunities within the Consumer Staples sector. We believe that our offensive strategy will continue to yield long-term investment outperformance for our clients.

Market Outlook

Positives do exist when fear grips a market as it did in the third quarter, though investors fail to see the positives around them. For example, the odds of a domestic recession have been receding as consumer spending has remained resilient and manufacturing has stabilized. In fact, GDP estimates have been moving higher for both the third and fourth quarters of 2011 and now stand between 2 and 2.5% for both periods. Similarly, while growth has slowed, earnings are also likely to prove resilient. Emerald anticipates that earning growth will continue to be significant in 2012, especially for the small and mid cap growth indices. Balance sheets remain flush with cash. Cash as a percentage of total assets for the average small capitalization company is hovering around 18% as compared to the 11% long-term average. Buyback activity has accelerated and merger and acquisition activity has continued, albeit at a more moderate pace. Further, while high yield rates have increased and bond values have declined significantly, deals are being done, providing important support.

While the domestic economic situation is looking moderately better, the same cannot be said for Europe. As a result, although volatility as measured by the VIX has retreated from its peak, it is likely to remain above historical averages as the market reacts and assesses the viability/inevitability of a resolution to the issues in Europe and the impact to both worldwide and domestic growth.

Emerald, as has been the case since the inception of the firm, remains focused on utilizing its fundamental bottom-up research process to identify the best growth companies within the small capitalization universe.

- October 18, 2011