EMERALD ADVISERS, INC.
2011 2ND QUARTER ECONOMIC & PORTFOLIO COMMENTARY

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GROWTH CONTINUES TO OUTPERFORM

2nd Quarter 2011	
Russell 2000 Growth	-0.6%
Russell 2000	-1.6%
S&P 500	0.1%

Global economic momentum slowed significantly during the quarter. Domestically, incoming data points on industrial activity, employment, consumer confidence and housing deteriorated meaningfully from trends witnessed during the first quarter. This constant stream of negative data combined with fears of slowing Chinese economic growth, an ailing Greek economy and rising concerns about the health of peripheral Europe collectively weighed on market returns. The give-and-take of economic data points during the quarter created volatility in the market place. Small cap growth actually fell 10.6% from April 29th to June 13th, a substantial correction due to the visibly weaker economic growth caused by the Japanese supply chain disruption, worries over Greece (plus its contagion effects), China's weakness, and the need to agree on a new Federal Government debt ceiling. The market then rallied significantly to end the quarter only modestly negative.

Given the heightened risk aversion, it is very surprising that growth continued its leadership role in the second quarter across all cap sizes with Mid Cap recording the best nominal return and greatest spread over its value peer group.

Emerald continues to believe that the backbone of this advance is corporate profits. Despite the apparent pause in the economy during the second quarter, we expect earnings to be above analyst estimates for the July reporting period. As reported by the Wall Street Journal, this recovery may be among the slowest in post World War II recoveries in terms of GDP growth, home prices, bank lending and total jobs, but it ranks well in terms of corporate profit recovery versus the average recovery.

Portfolio Performance

Defense was the best offense during the quarter as slowing economic growth and heightened risk aversion led investors to shed positions in the more cyclical economic sectors (energy, materials and producer durables) in favor of opportunities within the consumer staples, healthcare, and consumer discretionary sectors. Quality reigned as higher ROE, larger market capitalization companies outperformed higher beta, higher growth stocks. Despite this challenging backdrop, Emerald slightly outperformed the benchmark during the quarter as strong stock selection modestly offset the portfolio's exposure to the producer durables, energy, and technology sectors which trailed the benchmark in the quarter. Specifically, the portfolio achieved better than index performance within the consumer discretionary and consumer staples sectors, which was modestly offset by relative underperformance within the energy, healthcare and producer durable sectors.

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The consumer discretionary sector was the most notable contributor to Emerald's performance during the quarter. Stock selection within the restaurant, diversified retail, specialty retail and textile, apparel and shoes industries were the key drivers to performance.

While headwinds remain for the consumer, including stagnating employment growth and housing values, the recent decline in commodity prices (energy, cotton, grains, etc.) and better than expected June retail sales figures should help to ease concerns about deteriorating demand, at least in the near-term. As we look toward the back-to-school and holiday periods, performance of the sector becomes more uncertain. Regardless of the retreat that we have witnessed in the commodity basket of late, market prices are slated to move higher across the consumer products spectrum as retailers look to offset the higher costs paid for goods during the early part of this year. Given that we have not experienced inflation in many of these categories in recent memory, elasticity of demand remains a source of uncertainty. Emerald has positioned its consumer holdings in those companies we believe are positioned to benefit from ongoing consumer demand but at the same time have less exposure to commodity costs and thus are less reliant on price increases. The portfolio is currently equal-weight the consumer discretionary sector relative to the index.

The Consumer Staples sector was the best performing sector in the Russell 2000 Growth benchmark in the second quarter. We believe this was more of a reflection of the defensive posture of the markets than that of a fundamental improvement in the sector outlook as many companies are challenged to realize price increases sufficient to offset rising commodity costs, resulting in profit margin pressure. Emerald outperformed due to positive contribution from stock selection. We continue to believe that our offensive strategy, in what is often viewed as a defensive sector, will continue to yield long-term investment outperformance.

After consecutive quarters of positive contribution, performance within the technology sector was neutral to the overall performance of the portfolio. At the industry level, outperformance within the electronics and communications technology industries was mostly offset by weakness within the software industry. We continue to believe the industrial laser industry represents one of the market's most compelling growth opportunities over the next decade. In addition, we remain bullish on the growth prospects for Emerald's other laser-related holdings.

The relative underperformance in the software industry resulted from company specific issues. Despite company specific issues, stock selection within the technology sector remained positive which can be attributed to the breadth and diversity of the holdings within the sector. Although performance during the quarter was more challenging than anticipated, Emerald continues to maintain its positive stance on the opportunity and outlook for the technology sector.

Contribution from the aforementioned sectors was partially offset by relative underperformance within the energy, producer durables and healthcare sectors. As discussed above, performance within the more cyclical sectors of the economy struggled during the quarter as expectations for economic growth were ratcheted down globally and commodity prices retreated. Consequently performance within the energy and producer durables sectors were pressured both by the portfolio's relative positioning and stock selection. Within these sectors, underperformance was most pronounced within the following industries: crude producers, back office support and commercial vehicles & parts. While disappointed in the relative performance within these two sectors during the quarter, Emerald remains optimistic regarding the opportunities in the energy sector, most notably services; and the industrial complex, which continues to benefit from industrialization of the emerging markets, rising air traffic, the demand for more efficient aircraft, and industrial automation.

Emerald's performance within the healthcare sector also detracted from performance during the quarter primarily due to disappointing performance within the biotechnology and medical equipment industries.

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

Market Outlook:

Macroeconomic concerns as discussed in the beginning of this commentary have resulted in global economic growth estimates being lowered for the second quarter. However, the majority of forecasts are assuming a reacceleration of economic growth for the second half of the year. At the end of the quarter signs of improvement were already starting to support the market. These included the improvement in the June U.S. purchasing manager's index, the rebounding industrial production statistics for Japan, and in the stabilization of commodity prices. While there are some signs of improvement, the lack of net employment gains and the ongoing declines in the housing sector continue to weigh on consumer sentiment and remain a source of uncertainty to the second half growth story.

Although the overall macroeconomic environment has created a backdrop of uncertainty, Emerald sees several positives in the marketplace. First, individual stock correlations are declining and the spread in performance results are widening, according to Furey Research. We believe this is a normal progression at this point in the market's advance. It is natural for earnings growth to slow from the torrid pace recorded from the start of the market cycle and for the variation in earnings and performance of individual stocks to widen. We believe that this environment should be favorable for active managers, such as Emerald, that derive the greatest portion of their return through stock selection.

Second, Emerald expects corporate profit strength to continue to underpin future market advances as it has to date. To that end and given the recent macro-economic uncertainty, we expect the market to be keenly focused on the sustainability of earnings growth as we move through the upcoming earnings season. With more variability in the rates of growth, as discussed above, we believe growth companies posting both top and bottom line outperformance will continue to be favored by the investment community. Recent strength in the initial public offering market is evidence of this growth focus as social media oriented technology stocks (i.e. LinkedIn) bring new growth prospects to the marketplace. Following closely behind LinkedIn, companies such as Groupon, LivingSocial and Zynga are expected to enter the public marketplace in the second half of 2011. Emerald believes their acceptance and performance could be a meaningful indicator for future market advances.

Further, with cash on corporate balance sheets (both large and small cap) still at record levels, we continue to expect merger and acquisition activity to be an important part of the market landscape and anticipate a reacceleration in announced deals as we move into the second half. Companies in the small and mid capitalization spectrum should reap the greatest benefits as acquirers seek out market share gains and earnings growth opportunities. Emerald believes that all of the aforementioned factors: focus on earnings growth, strong initial public offering pipeline, an active merger and acquisition environment and a break-down in individual stock correlation provide a positive backdrop for stock pickers such as Emerald.

- July 19, 2011