EMERALD ADVISERS, INC.
2009 4TH QUARTER ECONOMIC & PORTFOLIO COMMENTARY

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ECONOMY GAINS MOMENTUM

	4th Quarter 2009
Russell 2000 Growth	4.14%
Russell 2000 Value	3.63%
S&P 500	6.04%

Fourth quarter gains across all of the broad market indices capped what really was a miraculous year. We entered 2009 with the financial crisis in full swing, and on the verge of what was believed to be the next great depression. We are ending the year with an economy that has stabilized and is poised for growth. What a difference a year makes. GDP estimates for the fourth quarter have been revised higher in recent weeks driven by stronger than expected quarter to date retail sales as well as recent noted increases in business inventory levels. Ed Yardeni, a well known economist, is leading the charge with a 6.4% estimate for fourth quarter economic growth, which is significantly above the more modest revisions in the 4 to 4.5% range and the existing consensus which is calling for GDP growth of 3.5%. Whether we end up at the high-end or low-end of that revised range for the fourth quarter remains to be seen, but what appears indisputable based on the aforementioned is that the economic recovery is ongoing.

The Russell 2000 index ended the year by gaining 8.05%, the third best December on record. For the year, the Russell 2000 Growth substantially outperformed the Russell 2000 Value index appreciating 34.47% vs. 20.58%. The relative outperformance of both the consumer discretionary and technology sectors as well as the relative underperformance of financials, were the key drivers of the outperformance of the growth benchmark.

During the fourth quarter, the Russell 2000 Growth again outperformed the value index, although it was by a much smaller margin of 4.14% vs. 3.63%. Consumer staples, energy and materials posted the greatest returns from a sector perspective. Decomposing returns further, as we have over the last two quarters, composition of returns within the Russell 2000 Growth did show some variation from the trends which dominated the second and third quarters in which the smallest market cap (sub $5) and lowest ROE companies reaped the greatest returns. In the fourth quarter, performance was dominated by the larger market capitalization and higher ROE companies in the index. Performance by long-term growth rates were again skewed away from the higher growth companies, but we believe this is more a function of the broad breadth of the market and believe that as market breadth narrows, the fastest growing companies will again begin to outperform.

From a portfolio perspective, the year ended on a high note as fourth quarter relative returns outpaced the benchmark. After a difficult second quarter, relative performance rebounded during the second half of 2009 enabling Emerald to outperform for the fourth quarter and the year. During the fourth quarter stock selection was the key driver to outperformance, due to better than index performance within technology, materials, consumer discretionary and healthcare. Performance in the technology sector continued to be the greatest source of relative outperfomance. Stock selection within communications technology, production technology equipment and semiconductors was the key driver of outperformance.

As we enter 2010, the portfolio is positioned to reap what Emerald believes will be the benefits of accelerating enterprise spending and the evolution of several product specific cycles. These include the Windows 7 upgrade cycle; the server refresh cycle driven by Intel's Nehalem EX chip; expanding storage needs due to the ongoing exponential growth in data, increased penetration of notebooks, netbooks, smartphones; and the impending release of the newly termed smartbooks, intelligent networking and next generation lighting. Lighting technologies are changing rapidly due to the advent of the light emitting diode. While not a new technology, reduced costs and greater efficiency have culminated to drive growth in this area. From a sustainability/"green" perspective, LEDs consume 30%-50% less power than traditional CCFLs (cold cathode fluorescent lamps), resulting in lower power consumption, a longer battery life and importantly LED's do not contain mercury, which is required for CCFLs. Additionally, the size advantages of LEDs over CCFLs are driving new, thinner, lighter, and more stylish consumer products. Emerald expects further proliferation of LED lighting in laptops, monitors, televisions and general lighting to name a few applications. The portfolio currently has several positions that are poised to benefit from this trend.

The materials sector also remained a source of outperformance due primarily to stock selection. Looking to 2010 Emerald continues to see ample of opportunities within the sector across a variety of industries including: basic materials, gold, and paper. The portfolio remains overweight the materials sector.

If the consumer as we know it is dead, it certainly wasn't obvious in the performance of the consumer discretionary sector, which was the best performing Russell 2000 Growth sector for the year. Fourth quarter performance at the index level was middle of the pack, but still outpaced the index overall, and was enough for consumer discretionary to come out on top for 2009. Within the Emerald portfolios relative performance in the category bested the index for both the year and quarter. During the fourth quarter excess return was derived from stock selection within diversified retail, textiles & shoes, and consumer services. E-commerce was alive and well during the fourth quarter, as consumers accelerated their online purchases. While the final holiday sales figures are still being compiled, preliminary estimates from Mastercard Spending Pulse online indicate that sales grew 17% for the November-December period.

Emerald has gotten increasingly optimistic regarding the opportunity set with the consumer discretionary sector as evidenced by the portfolio's move from an underweight position to an overweight position over the last two quarters. We believe that consumer spending over the course of 2010 will likely be better than current expectations as a function of a more rapid recovery in the jobs market. That macroeconomic opinion is the icing on the cake, as Emerald believes each one of its portfolio holdings, even in a more moderate spending environment has the opportunity to outperform the market overall due to the combination of new product cycles, market share gains, international expansion and margin improvement.

Relative performance in the healthcare sector showed improvement in the quarter. After a challenging last two quarters, performance within this sector bested the index driven by stock selection. While stock selection was a positive during the quarter, the healthcare sector as a whole has continued to lag the market due to the ongoing uncertainty surrounding healthcare reform and the potential impact to revenue and earnings growth. This uncertainty has been the primary driver behind the portfolio's underweight position throughout this year. In 2010, we believe the passage of the healthcare reform will remove the uncertainty that has compressed multiples in the sector. Further with the rules of the game defined, Emerald will be in a better position to differentiate the winners from the losers. Today, the portfolio is weighted more heavily toward the stocks of companies which work to administer the health care system as Emerald expects the net expansion of lives into the system to accelerate earnings. Similarly, the portfolio is underweight the stocks of companies that manufacture products consumed by the healthcare system, as we are unsure how these companies will be compensated post healthcare reform.

Performance in the areas mentioned above was partially offset by weakness within the financial sector. While we have underweighted this sector, the portfolio's industry overweight in community banks was a detriment to performance. Community banks raised a considerable amount of offensive capital in the second half of the year to expand, take market share, and execute FDIC related takeovers. While these macro events were encouraging, the market in the fourth quarter expressed greater concerns over asset quality specifically.

As we enter 2010, the portfolio is positioned for cyclical strength with overweight positions in technology, materials and consumer discretionary. Stock selection remains paramount. Market breadth is widely expected to narrow in 2010, which should bode well for Emerald's bottom-up fundamental style. Emerald believes growth stocks are likely to continue their streak of outperformance given our optimistic outlook toward the cyclical economic sectors and the headwinds that face the financials.

Outlook

Coming off of a nearly 35% return year for small caps, it might sound counterintuitive to say that we are quite optimistic about the coming year, at least economically. Whether this is priced into the market will really depend on the magnitude of the upside and will likely be a point of debate for the bulls and the bears throughout the year. While not expecting the same relative nominal return environment, we are more sanguine about the overall level of economic activity that we should see as this recovery unfolds. Given our company specific fundamental view, we would conclude that there is probably more momentum in the underlying economy than is widely recognized by consensus expectations. We would note that even historic precedent would render you quite bored with our present pace of recovery, which by some economic regressions should have real GDP rebounding in the 6-8% range, given the depth and severity of the 2007-2009 downturn. While we wouldn't predict numbers of that magnitude, we would say that you should be prepared for above consensus growth, which will feed the corporate profit cycle and eventually lead to higher employment numbers.

The signposts for an improved labor market are already visible to those of us that dig beyond the basic headlines. Temporary staffing, a consistent and reliable leading indicator of future full employment trends has been growing for the last 5 months. In the fourth quarter of 2009, the temporary staffing industry added more jobs than in any other three month period going back to the early 1990's. As reported in the Challenger, Gray and Christmas December report, "planned firings" were down 73% from last year and down 10% sequentially marking the fifth month of consecutive declines: "we may see a quicker turnaround in the economy than many suspect…these cuts are more inline with periods of expansion." We find ourselves in agreement with economists like Michael Darda of MKM Partners who expect positive employment numbers beginning in the first quarter of 2010. The recent ISM Manufacturing Index reading above 55 seems very bullish for future employment. As it turns out, the ISM's rise to 55 appears to be the quickest such rise following a business cycle trough since the recoveries of 1961 and 1980; in every instance it has crossed 55 coming out of recession, the three-month average growth rate in non-farm payrolls was positive. That would put positive payroll growth within the next few months, much sooner than many anticipate.

Why do we care? The obvious answer is because health in employment drives so many other dynamics of our economy – from consumer confidence to consumer spending and finally to corporate expansion. Recessions cause job losses and they elicit such overused terms as "structural" and "permanent" changes to the labor market. The U.S. economy has shed an astounding 7.2 million jobs during this recession. However, almost 80% of those job losses came *after* September 2008 when the credit markets collapsed. If you look at the relationship between the rise in unemployment traditionally for a given fall in GDP, it is our belief that business over-shed workers – we had "too much rise" for the actual decline in GDP. With stability in the credit markets returning and a cyclical rebound underway, some of these jobs will come back even if the U.S. economy doesn't return to peak employment. With jobs comes incomes and improving psychology; with incomes comes growth.

Growing employment, expanding incomes and growth in consumption (both from the individual and the corporation) create a positive feedback loop which has been so elusive in recent years. The massive inventory liquidation of the past year is giving way to a fairly robust replenishment cycle. Old Mother Hubbard's cupboards are just about bare – if you just went from the $139B rate of liquidation in the 3rd quarter to $0, it would add 4.2% to GDP. The key will obviously be end demand, but we may be at the inflection point where the "virtuous cycle" has some room to stretch its legs. Emerald's positive expectations on GDP growth lead to a positive read on corporate profits. With the cost cutting efforts of the past 12 months still fresh in management's minds and still in corporate budgets, we would anticipate a prolonged margin expansion opportunity unfolding for well run companies. And with credit spreads narrowing and an equity market firmly past the "rebound trade", quality companies should again begin to garner premium valuations (the oft spoken of, but sparingly witnessed "quality trade.")

A historically steep yield curve is unambiguous about growth. Emerald's expectations are for a recovery – a recovery in the economy; a recovery in the corporate profits cycle; and, most importantly, a recovery in the attention paid to strong, dynamic growth companies. The markets have had the rally resulting from the "next Great Depression scenario" being taken off the table. From here, the individual company fundamentals should again matter. From here, superior business models should again demand premium valuations. And from here, actively-managed, research-based portfolios should again begin to outperform.

-January 19, 2010