EMERALD

EMERALD ADVISERS, INC.
2010 2ND QUARTER ECONOMIC & PORTFOLIO COMMENTARY

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2ND QUARTER CORRECTION

	2nd Quarter 2010
Russell 2000 Growth	-9.2%
Russell 2000 Value	-10.6%
S&P 500	-11.4%

What a difference a quarter makes. We entered the second quarter with a strengthening economy, low volatility as represented by the VIX, a 10-yr U.S. Treasury Bond yield at 4% and an equity market that, in our opinion, remained biased to the upside. But as has been the case in the financial markets, when change ensues it tends to do so abruptly. The equity market, which had been climbing since March of 2009, finally moved into the correction phase for which both bulls and bears had been calling. The bears did not believe the market advance was justified by the sub-par economic picture and the bulls hoped for the euphemistic "pause that refreshes" to consolidate the market gains in order to position for a higher quality second leg of a market rally. This, however, was not to be. As the wall of worry continued to build the market shot through 5 to 10% correction levels within ten trading days and proceeded to decline by 20% as we entered early July.

There are plenty of issues over which to be concerned, the most pressing of which is the risk of contagion in the sovereign debt marketplace. Over the last few years the bond vigilantes have caused a paradigm shift in investor's attitudes toward leverage. This shift began with the demise of two of Wall Street's venerable firms: Bear Stearns and Lehman Brothers, both of which employed irresponsible amounts of short term leverage in order to finance long-term strategies. Now fast forward to 2010, we are seeing a similar story play out in the European sovereign debt market. The most notable example has been Greece where debt as a percentage of GDP has risen to historically high levels. The bond vigilantes responded driving credit spreads dramatically wider, limiting Greece's ability to rollover its debt, and in so doing sent a strong message to Greece's government officials that the market is no longer willing to finance the country's excess. Greece is not alone and with the market's renewed focus on fiscal discipline, there is risk that attention may begin to shift to other countries like Spain, Hungary, Great Britain, Japan, and the rest of the Far East that have also fostered these excesses. If the bond vigilantes continue on this path the United States will not likely escape this process unscathed.

At a time when the world is focused on de-leveraging, the U.S. is embarking on a path of bailouts that has seemingly no end. Washington has been notoriously lax as it relates to fiscal discipline. As a result the United States ultimately may be faced with the same reality as Greece as foreign buyers of America's debt refuse to further support our domestic excesses (the Keynesian expansion, health care reform costs and social welfare platforms).

Long-term, we are concerned that global debt burdens and state and local deficits run the risk of hindering U.S. growth prospects. The growing U.S. debt burden needs to have a release valve. Since fiscal discipline is likely to remain elusive, the only way to contain this growing debt burden is through better than anticipated economic growth and higher tax receipts. In this regard, the lack of confidence in the health of the current economic recovery is a real concern. Will the spending of 2009 and the temporary staff hiring turn into a second leg of this current recovery? To prolong the cycle, provide tax benefits and allow for the housing recovery to take hold, confidence must be reversed to late 2009 levels. The risks are obvious in that a short cycle doesn't allow the Fed to raise rates, doesn't allow the bond market to regroup, and doesn't allow the real estate cycle to break its deflationary grip on asset values.

Will a Keynesian response work next time? Certainly not, if it follows too close to the last cycle. The bond vigilantes would not allow it, and the Federal Reserve would be forced to print money until runaway inflation is in full effect. Hard assets will benefit from this scenario but the rest of the market will spiral downward – not a pretty sight.

Portfolio Performance

Catalyzed by concerns over the potential for a double-dip, all of the broad market indices posted negative returns for the quarter. Volatility spiked (although still remains significantly below its prior peak), spreads widened and the 10-year treasury yield sunk below 3% as risk aversion rose. The Russell 2000 posted the worst second quarter in the history of the index declining by -9.92%. Despite this, small capitalization Russell 2000 Growth stocks managed to maintain their lead against the larger Russell 1000 Growth index counterparts. From a sector standpoint consumer staples, materials and financial services led while consumer discretionary, energy and healthcare lagged.

Performance in the Emerald portfolio outpaced that of the benchmark for the second quarter as a result of stock selection within healthcare, energy, technology and consumer discretionary.

In the face of what was again another challenging quarter for the overall healthcare sector, Emerald's performance bested the index driven by stock selection. While we see limited catalysts on a sector basis given reform and pressure on states to reduce costs, we continue to believe there remain niche opportunities on which to capitalize. The portfolio as of June 30, 2010 moved to a modest underweight position relative to the benchmark. The relative shift in positioning can be attributed to the impact from the Russell rebalance at the end of June, which reduced the healthcare weight in the benchmark by nearly 300 basis points. This shift accounts for the entirety of the relative change in the underweight position and does not represent any change in strategy on behalf of Emerald.

Performance within the energy sector was the second largest contributor to return during the quarter. This was particularly notable, given that the energy sector was the worst performing sector in the Russell 2000 Growth, underperforming the aggregate index return by in excess of 600 basis points. Despite this headwind, the Emerald portfolio posted strong relative performance due to stock selection. Performance was led by on shore oil-weighted exploration and production names, and service companies that are benefiting from the tremendous ramp up in shale drilling activities. The Emerald portfolio was positioned to take advantage of both of these factors through overweight positions which were leveraged to production growth in the Bakken oil shale formation. The portfolio remains equal-weight to the energy sector.

Second quarter performance in the technology sector improved on a relative basis outperforming the Russell 2000 Growth index overall. Although macroeconomic concerns have caused recent volatility and uncertainty, some of the secular trends that we have discussed in prior notes such as the transition to light emitting diodes (LED), growth in wireless networking, intelligent networking, on-demand software and cloud computing have continued to evolve and positively impact performance. Demand for LED's used in televisions, notebooks and traffic lights has accelerated driven by favorable lighting characteristics, lower power consumption, declining price points and other "green" attributes. The accelerating demand for LED's has subsequently driven demand for sapphire wafers. With demand for sapphire wafers accelerating and supply constrained, pricing and thus earnings estimates should continue to be biased to the upside. Now with the LED transition in full gear, the market and Emerald alike are looking ahead to the next generation lighting technology known as OLED or organic light emitting diodes. While investor sentiment regarding a global slowdown in economic growth has become increasingly cautious, these secular opportunities keep us optimistic. The portfolio remains overweight technology.

After a strong first quarter and trailing 12-months, performance of the consumer discretionary sector deteriorated meaningfully in the quarter as data flow turned decidedly negative. Consumer confidence slid, private sector job creation stalled, retail sales figures decelerated, housing figures disappointed and with the revaluation of the Chinese yuan, the rise in labor costs in China appears poised to accelerate. Despite all of these factors and the significant retrenchment in absolute performance, stock selection led Emerald's relative outperformance. Although the macroeconomic picture regarding consumption has gotten murkier over the last few weeks given the statistics mentioned above, we continue to remain cautiously optimistic, believing that even in a more moderate consumption growth environment, companies with innovative products can continue to thrive. The portfolio remains overweight the consumer discretionary sector.

Performance within the producer durables sector was the most significant detractor to return driven primarily by the portfolio's staffing industry holdings. Although we have reduced weightings, given the economic headwinds, temporary staffing has continued to grow, and if we are indeed undergoing a structural change in the workforce where utilization of temporary workers remains high, we would expect the staffing companies to benefit. The portfolio remains underweight the producer durables sector.

Contribution from both materials and financials were essentially neutral to performance. The portfolio remains overweight the materials sector based on stock specific opportunities within the sector. In financial services, the portfolio has maintained its underweight position to the sector overall, although overweight the banking industry. While remaining cautious as it relates to asset quality, Emerald continues to believe that inflows to non-performing loans peaked in the fourth quarter of 2009 and that the next catalyst for bank stocks will occur in the second half of 2010. At that time we expect to see total nonperforming assets at the higher quality community banks begin to decrease. We believe investor's focus will then turn to pre-tax and pre-provision earnings as a differentiator and catalyst for valuations.

Outlook

As we look forward Emerald continues to believe that the U.S. remains the world's innovation engine. In that regard, we believe the technology sector and the biotech sector hold particularly attractive opportunities for small cap investors in the future. Opportunities are abound in both segments over the next decade, so much so, that Emerald has recently published two white papers on each segment (please contact your Emerald representative if you are interested in these documents). While valuations and specific trends and events will dictate our short term weightings, the long term opportunities, as detailed in our reports, are indeed quite significant. Please note that these two segments of the small cap growth universe were significant underperformers in the last decade. The significant underperformance of small cap growth vs. small cap value was attributable to both of these important segments. Emerald believes the current decade will represent a change in the fortunes of biotech and technology, therefore benefiting growth investors vs. value investors.

Emerald's portfolio positioning has always been derived from a bottom-up perspective. Our investment outlook is based on the real-time information derived from the field (on-site investment research, industry contacts and channel checks). In addition, Emerald employs the philosophy best exemplified by Wayne Gretzky's famous quote "I skate to where the puck is going to be, not where it has been". In that regard, as we look forward, Emerald's fixed income team and their insight into financial spreads and yield curve analysis provides a fundamental insight into economic growth and market risk sensitivities. For example, today's steep yield curve portends a strong economic future. While spreads in high yield bonds, credit default swaps and high quality corporate bonds have risen in the last few weeks, the collapse in spreads since March of 2009 has indeed given the economy more than enough momentum to continue its upward movement for 2010. The rise in spreads has caused our expectations for growth to be more muted over the short term than we previously expected. Currency concerns have brought into question the rate of export growth for U.S. companies. While this favors small cap companies given their larger domestic exposure, it is still a negative for GDP growth that will inhibit short term expectations and therefore valuations.

Confidence may be the deciding factor today. Why didn't technology work in 2007-2008? Not because innovation died, or ROI wasn't desirable. It was because the corporate suite was concerned with survival: preserve cash, hunker down and protect market share gains – risk is for another day. This attitude did indeed change in 2009, as software sales soared and enterprise spending drove the economy over the last nine months. Confidence however, as witnessed in prior periods, can be fragile; and while corporate balance sheets remain strong, any change in the outlook in the corporate suite can alter the trajectory of spending intentions.

- July 15, 2010