EMERALD ADVISERS, INC.
2010 3RD QUARTER ECONOMIC & PORTFOLIO COMMENTARY

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QE2 AND MERGER ACTIVITY A POSITIVE

	3rd Quarter 2010
Russell 2000 Growth	12.83%
Russell 2000 Value	9.72%
S&P 500	11.29%

The quarter began amidst the first correction since the market recovery started in March, 2009. The market was concerned about a double-dip recession, as employment trends did not appear to follow the upturn in temporary employment or the stock market portfolio rise in the prior 12 months. Consumer and stock market psychology seemed to be tied at the hip, and both were turning south rapidly. Housing remained a key overhang as the end of the tax rebates saw home sales plummet. Fears of foreclosure still rising behind a clogged pipeline, unemployment rates still significantly over 9% and new worries over deflation means a housing recovery may be another year or more away. While housing prices rose significantly in most markets in the spring, the concerns cited above were enough to pressure consumers to pause in their buying of homes as well as apparel and other consumer goods. With economic growth remaining below the Federal Reserve's target as measured by employment, inflation and gross domestic product the call for a second round of quantitative easing (QE2) began to gain momentum in the market.

At the same time confidence was growing that Federal Reserve was set to embark on a second round of quantitative easing, merger and acquisition activity shifted into overdrive catalyzed by the public bidding war over 3Par by Dell and Hewlett Packard. After several counter offers Hewlett Packard prevailed, placing a multiple on 3Par that surpassed even the most aggressive estimates. As more deals followed, multiples adjusted higher, contributing to the index leading returns posted by the technology sector during the quarter.

Although the technology sector was the source of some the most prominent merger and acquisition activity, deals were getting done across the board, as both corporations and private equity players stepped up. The Wall Street Journal reported that M&A deals grew by 55% in the 3rd quarter versus last year and totaled over $75 billion worldwide. Even prior to the September flurry of deals, the number of deals announced in the small capitalization space was tracking significantly ahead of those announced during 2008 and 2009, according to a recent report from Bank of America Merrill Lynch. With corporate cash balances at historical highs across the market capitalization spectrum, and debt funding rates low, we fully expect activity levels to remain accelerated. This should also lead to a better IPO market over the next year which will benefit active managers like Emerald who can take advantage of these new opportunities.

With M&A driving enthusiasm in the technology sector and the expectation for QE2 propelling commodity prices, the market was able to record strong double digit returns. Leadership within technology, materials and energy enabled growth as a classification to return to dominance as Mid Cap Growth, Small Cap Growth and Large Cap Growth all led their respective peers for the quarter.

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Portfolio Performance

The Russell 2000 posted its best ever gain in the month of September, gaining 12.5%. Risk tolerance fluctuated significantly during the quarter as did absolute returns. Notably while small caps performed in line with the S&P 500 for the quarter, the Russell 2000 outperformed by 300 basis points in the month of September, according to Furey Research, driven by accelerating merger and acquisition activity and the rising probability for a second round of quantitative easing by the Federal Reserve.

While small capitalization stocks surged in September, active managers as a group continued to struggle. According to a recent report from Tom Lee of J.P Morgan, less than 40% of small cap growth managers beat the index in the third quarter, 44% of Small Cap Growth managers are trailing their benchmark by 500 basis points on a year-to-date basis or more this year, and 42% trail by 500 basis points over the last 3 years.

With that backdrop, we are encouraged to report that Emerald outperformed the index this quarter. This was due to better than index performance within technology and producer durables, which was partially offset by underperformance within the consumer discretionary, financial services and material sectors. Performance within the healthcare sector was inline with the benchmark. The most notable aspects of quarterly performance are detailed below.

Performance within the technology sector again dominated both index returns and the portfolio overall driven by solid fundamentals and an acceleration in merger and acquisition which drove multiple expansion. The Hewlett Packard/Dell bidding war for 3Par and the significant premium ultimately paid by Hewlett Packard led to a revaluation in those companies identified as beneficiaries of the secular trends in cloud computing, wireless networking, intelligent networking, storage and on demand software. Emerald added aggressively to its technology exposure during the early part of the quarter, particularly in software, and as a result, was well positioned to capitalize on the aforementioned. Sector outperformance was most notable within the communications technology, software and the computer technology industries. Emerald's portfolio was positively impacted both directly and indirectly by the wave of acquisition activity within the both the business intelligence and cyber security markets.

As we move into Q410, the technology sector remains the portfolio's largest overweight position. The overweight position is predicated on the belief that the enterprise spending budgets are being prioritized toward the areas such as on-demand software, intelligent networking, wireless networking, storage and cloud computing. As we look toward the balance of the year Emerald remains optimistic regarding the opportunities within technology sector related to the secular trends identified by the Emerald Technology team.

Strength in aerospace and machinery contributed to outperformance within producer durables this quarter. The portfolio is equal-weight the producer durables sector.

Partially offsetting the performance within the technology and producer durables sector was disappointing performance within the consumer discretionary sector. The consumer discretionary sector continued to lag the index overall as rising costs, the ongoing lack of employment growth, slowing sales momentum over the summer months, and the lapse of the home buyer tax credit raised concerns regarding the sustainability of earnings growth during the second half of 2010. These factors combined with generally more muted commentary from company management on their second quarter conference calls helped drive significant uncertainty. These factors weighed particularly hard on the home furnishing related companies. The portfolio also experienced weak relative performance within specialty retail, diversified retail and consumer services due to disappointing stock selection.

After a volatile August, the consumer discretionary sector rebounded nicely in September, as the early quarter concerns about the demise of the consumer proved again to be overstated as consumers flocked back to stores in September resulting in almost universally better than expected results. As we look toward the all-important holiday quarter, early forecasts have reflected optimism. The National Retail Federation, in its recently released survey, estimated that sales would grow 2-3 percent for the holiday period. For our part, Emerald remains cautiously optimistic. The portfolio remains focused on those companies positioned to benefit from innovation and market share gains.

Entering the fourth quarter the portfolio is currently overweight technology, consumer discretionary and energy and underweight healthcare, materials and consumer staples.

Market Outlook

Historically, according to Furey Research, strong performance in the month of September has often served as a precursor to solid year end performance. This year could be setting up to have the same result as of ongoing merger and acquisition activity, better than expected third quarter earnings reports, a positive pro-business outcome to the mid-term elections, an extension of the Bush tax credits and the initiation of a second round of quantitative easing by the Federal Reserve could serve as positive catalysts. According to a recent survey by Bank of America Merrill Lynch approximately 80% of investors surveyed expect a QE2 response either at the November meeting or by first quarter 2011 at the latest. The market's conviction has been growing since early September and the lack of acceleration in the September Bureau of Labor Statistics report seemingly has cemented the market's conviction. The biggest debate now is not whether it will happen but how big it will be and the time frame for implementation.

This massive monetary push expected on November 3rd (a day after the elections) provides us a favorable overall view of equities in general and, in particular, materials and industrials. The question is how much of this is already incorporated in commodities prices and whether the Fed can change investor attitudes vs. just providing another short-term stimulus (re: sugar high). Admittedly we have our misgivings as to whether QE2 will work or is even needed.

While Emerald is positive in the near-term outlook, the market still has a considerable wall of worry to climb. Housing foreclosures, while stalled in the near-term, are clearly not behind us. The number of Americans living below the poverty level has risen to the highest level in 50 years and appears to still be climbing. Pension funding gaps for both public and private funds will continue to be an overhang on the economy for many years in the future. Mutual fund flows continue to be negative, as retail investors are seeking returns from almost every asset class imaginable, except for equities. Given the events of the last two years, the "flash crash" being the most notorious thanks to CNBC's constant discussion, market psychology has been severely damaged by the events of the last two years. Although the SEC recently concluded its investigation, uncertainty remains regarding the exchanges' and/or the regulatory authorities' ability to prevent a reoccurrence. Consequently the retail investors' aversion to equities is unlikely to change as long as trading strategies continue to trump investment strategies in determining the direction of the marketplace. Given the structural nature of many of these concerns it is unlikely that this wall of worry will be dismantled quickly.

In spite of these issues and those that have plagued the market over the better part of the last 2.5 years, Emerald has been able to effectively navigate the turmoil, volatility and high market correlations through our commitment to the fundamental, bottom-up investment philosophy and process that has been in place since the inception of the firm.

- October 12, 2010