



## The Market

*“The Chinese use two brush strokes to write the word ‘crisis’. One brush stroke stands for danger, the other for opportunity. In a crisis, be aware of the danger – but recognize the opportunity.” [John F. Kennedy].*

Many market participants have adopted one of three views. First, the negative view for those who believe things are bad and will continue to get worse. Second, the positive view is for those who believe the current situation is bad, but that stock prices have effectively priced in the negative data. Finally, the opt-out view is for those who have opted out due to the heightened uncertainty of an environment where the rules change on a daily basis. Many investors go through the normal risk/reward debate of the first two examples many times during their lifetime. It is a special circumstance that drives them over the top in determining the current environment is too difficult to and forcing them to the sidelines. Today it feels like more and more investors are in this latter camp.

## Risk and Reward

Not long ago, the rage in the investment community was to find solidly profitable growing companies whose balance sheets were “under-levered” and raise a few billion dollars at very low interest rates in order to lever up the current operating business. The financial engineers figured they would be able to increase the earnings power in a very “low-risk” transaction and drive the company’s value ever higher thus demanding a much higher stock price along the way. This does nothing to change the enterprise value of a company but instead creates a new company “on steroids” and puts equity holders at risk in the form of debt which must be repaid before they receive anything. This period focused heavily on the perceived Reward and not enough on the real Risk taken to achieve it. Now, the pendulum has swung in the opposite direction. Today, investors are keenly focused on risk and have disregarded the future reward of investing in the vast majority of publicly traded companies. As investors rush into the “safety” of treasury securities they have bid up the prices so much that they now yield about 0.25% on short term treasury bills and 10 year Treasury bonds yield a meager 2.5%. The current environment of panic has centered on the fear of permanent loss of capital. Investors have been more concerned with the return “of” their capital rather than a return “on” their capital. We believe this latest fascination with US Treasury Securities, and their perceived safety and security during this historic period, will be the next area of pain for many investors. To be sure, the economic recession, near banking system collapse, a new government administration, emergency government bailouts, commodity price volatility, and corporate/financial scandals have all combined to create systemic fear among investors. The result of this over-baked fear may be a new bubble forming in the perceived safest investment possible. As dire as the current situation is, we must remember that there are a number of positives in the system as well: lower energy and commodity prices, low interest rates, a sizable government stimulus package and very attractive equity valuations to name a few. Focusing too much on negative events without context ignores the fundamental risk vs. reward tradeoff essential for successful long term investment. We believe this is creating tremendous opportunities for investors like us who focus on buying pieces of businesses at attractive prices.

In this aftermath, stock prices have come under tremendous pressure as the worldwide economy has weakened and growth in many sectors have been temporarily delayed. We believe some sectors will take many years to recover, and many companies

like AIG, Fannie Mae, Washington Mutual, Bear Stearns and General Motors will never come back for today's equity holders. We feel the majority of companies outside of these heavily debt-laden areas have fantastic secular growth drivers and wonderful opportunities to emerge from this malaise much stronger.

## THE PORTFOLIO

As we open 2009, it seems as if not much has changed since 2008. The market continued its volatile ways as the VIX (Volatility Index) has registered a reading above 40 for 51 days in 2009 and has not been below this mark since the first part of January. This volatility proves to us that investors were still afraid and confused. But, by the tail end of the quarter there were a few signs which give us the confidence that things are changing to the positive.

As we have stated many times in the past, the first quarter of the year is generally the time when companies report their year-end results for the previous year and attempt to give guidance for the year ahead. In this post Sarbanes-Oxley world, most management teams like to be very conservative and use the current events to shape their overall tone and expectations going forward. This year is no different except for the fact that many companies have decided to give no guidance whatsoever. We actually applaud this as it allows the companies to run their businesses for the longer-term without concern for what they may report over a specific 90-day reporting period. Instead, they have better flexibility in managing and growing their businesses during this difficult time. As a small-cap investor we have witnessed how many analysts determine their earnings models for a specific company. They generally do not update them during the quarter since many who cover small-cap companies do not want to do the work necessary to effectively track these smaller names, where information is not readily or publicly available. Thus, they are relegated to being what we call "reporters" versus "analysts". The consensus thinking is that the economy is in very bad shape and every sector of the economy needs a bailout, when in-fact this couldn't be further from reality. When this type of sentiment persists, expectations about the future are ratcheted downward and the analyst community follows. This time, it looks like the analysts have adjusted too far to the downside and become overly pessimistic heading into the first few quarters of 2009. This is a good thing for equity investors, because perception is a very powerful force in the markets. If a company is "perceived" to be performing better than "expectations" it is looked upon favorably even if the overall growth year-over-year is negative. Investors may look at the company as if they are ahead of their plans for the year and believe the equity price must go up in the near-term. Therefore, toward the tail-end of 2008 and early 2009 the trend within the analyst community has been to have your earnings estimates the lowest on the street. This fear driven race to the bottom has now gone a little too far in many cases and we are now seeing companies within the consumer and technology areas reporting results which are better than these rock-bottom estimates in which the current stock prices seem to be based. Now, these reporters are playing catch-up but many still don't believe things are getting any better. We believe this low expectation environment is the perfect backdrop for an improving stock market going forward and valuations relative to future growth potential are the best we have seen in many years.

As we scan the returns by sector we found not a single sector in the Russell 2000 Growth index had a positive return for the quarter, eerily similar to 2008 where the best performing sector was -19.99%. In contrast, we had a couple of areas where our stock selection and overweight stance helped us outperform during the quarter. We believe the near-term crisis is generally behind us and still feel there will be some large high-profile bankruptcies which will make the headlines, but in general a premium will be placed on stock selection going forward versus what we have seen for the better part of two years.

	Russell 2000G Average Weight 1/1/09 - 3/31/09	Russell 2000G Return 1/1/09-3/31/09
Healthcare	27.00%	-10.00%
Information Technology	21.70%	-0.49%
Industrials	18.96%	-19.96%
Consumer Discretionary	13.08%	-1.66%
Financials	5.46%	-15.87%
Energy	4.95%	-21.85%
Materials	3.13%	-15.54%
Consumer Staples	2.78%	-4.25%
Telecom Services	1.96%	-0.70%
Utilities	0.94%	-4.94%

Source: FactSet

Our single largest detractor in 2008 was our overweight stance in Technology. As a hedge-fund favorite for the past few years, this group was overly punished during the deleveraging of 2008. But, our unwavering confidence and knowledge of the group kept us overweight and so far in 2009 our Technology weighting was our single best performing group gaining +7.74% versus the index return of (-.49%) thus our decision to stay overweight this cash-rich growth sector helped us with outsized gains here. Also, we were slightly overweight Financials, and our continued avoidance of the banking sector allowed our Financial stocks to report a +10.33% gain versus the index return of (-15.87%). We continue to focus on transaction oriented companies versus lending institutions in the sector. The primary detractor during the quarter was our Healthcare position. We have tended to focus more on established companies in the Healthcare group versus many companies in the index who tend to be early-stage biotechnology companies within this sector. There were quite a few acquisitions by larger pharmaceutical companies of some smaller biotechnology names within the index during the quarter which helped enhance the index returns along with some high-profile drug approvals which drove these stocks higher. Our focus on established drug companies, medical devices, monitoring, and service companies tended to underperform as hospital budgets have been temporarily cut during the downturn. The slowdown at many of these companies is not nearly as large as the current stock prices reflect and in many cases we continue to hold and add to our existing positions in this group. Their products continue to be used on a daily basis in all facets of healthcare and provide hospitals with critical products along with the high return-on-investment they most desperately desire today.

## OUTLOOK

The US Economy has been under severe pressure the past few quarters, most recently reporting Q4 GDP contracted -6.2%, the largest quarterly decline since 1982. Much has already been written regarding this recent period. After speaking with the management teams of many companies, it is clear business slowed markedly in the November period across nearly all industries but since that point, many businesses have seen a nice steady uptick through March of 2009. This is why we believe it is of utmost importance to find good niche companies with strong balance sheets so they can weather any storm. While it is no secret that the economy is difficult, we believe we have seen the worst of the fundamental declines in Q4 and are seeing steady improvement in the early part of 2009. Companies with strong balance sheets are strengthening their business during these

down times, while weaker, heavily-levered players are attempting to renegotiate their bank credit lines versus running their businesses every day.

The major problem today is that the headlines from the financial stocks (Banks and Insurance companies) are overshadowing every other sector of our economy and seem to be infecting stocks even if they have nothing to do with toxic debts and mark-to-market. These macro headlines have put a lid on share prices in many sectors that we believe under normal circumstances should have reacted more favorably in recent weeks and months. It will take time to rebuild confidence, but we feel that a diversified portfolio of cash-rich companies and good growth prospects will be the first companies' investors flock to as the markets come back.

Going on our 14th year of investing in the markets, the Sparta team has gone through and weathered many panic scenarios. We can tell you one thing; they never ring a bell at the bottom to tell you when to get back in. What we do know is that the only way a "stock-holder" of a good operating business suffers a permanent loss is if that good operating business has too much debt. In that case, when things get tough, the bond holders have the ability to completely wipe-out all the shareholders and start over through a Chapter-11 proceeding. This is why at Sparta, our constant focus is on investing in small-cap growth companies with businesses and balance sheets built to weather these storms and emerge stronger when the clouds clear.

*"Over the past 25 years or so, we have seen a significant number of episodes of financial shock in U.S. markets and globally. Although more different than similar in their nature and impact, they had some common features. They were unanticipated. The causes varied, with some associated with a substantial deterioration in the real economy, and others not. And they typically involved the dynamic in which a sharp change in risk perception results in a fall in asset prices, a sharp reduction in market liquidity and an increase in correlations across asset classes. As market participants move to protect themselves against further losses by selling positions, requiring more margin and hedging against further declines, the shock is amplified and the brake becomes the accelerator."*  
**{Treasury Secretary – Timothy Geithner}**

As always, we assure you that our focus is singular and our efforts vigilant. Thank you for your continued confidence and support.

Ryan Carr  
Chief Investment Officer  
Sparta Asset Management



## U.S. SMALL CAP GROWTH EQUITY DISCLOSURE

Sparta Asset Management, LLC (SAM) US Small Cap Growth Equity Composite consists of fully discretionary equity portfolios seeking to achieve long-term capital appreciation by identifying securities of small-capitalization growth companies with the potential for significant long-term price appreciation. The composite is measured against the Russell 2000 Growth Index. The minimum account size for inclusion in the composite is currently \$5,000,000. From September 17, 2007 through September 30, 2008 the minimum account size was \$250,000. From July 1, 2005 through September 14, 2007 the minimum account size was \$1,000,000. Prior to July 1, 2005 the minimum account size was \$100,000.

Sparta Asset Management, LLC has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).

Sparta Asset Management, LLC is a registered investment advisor. The firm maintains a complete list and description of composites, which is available upon request.

Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance is not indicative of future results. Inherent in any investment is the potential for loss.

The US Dollar is the currency used to express performance. Returns are presented gross and net of management fees and include the reinvestment of all income. From 7/1/07 to present, net of fee performance was calculated using highest management fee of 1.00%. Prior to July 1, 2007 net of fee performance was calculated using actual management fees. Prior to July 1, 2005, the composite was comprised of 100% bundled fee accounts and net of fee returns during this period are net of all fees. The bundled fee includes all advisory, trading, custody, and administrative fees charged to the portfolios. The annual composite dispersion presented is an equal-weighted standard deviation calculated for the accounts in the composite the entire year. Additional information regarding the policies for calculating and reporting returns is available upon request.

The management fee schedule is as follows: 1.00% on first \$25 million; 0.85% on next \$25 million; 0.80% on next \$50 million; and 0.75% on assets over \$100 million. Each client's returns will be reduced by the advisory fee and any other expenses incurred in the management of the investment advisory account. Actual investment advisory fees incurred by clients may vary.

The US Small Cap Growth Equity Composite was created on September 17, 2007. All performance shown prior to September 17, 2007 is that of the Small Cap Growth Equity portfolio composite managed at a prior firm. The Portfolio Manager was the only individual responsible for selecting the securities to buy and sell. Performance shown from the prior firm does not necessarily indicate how the US Small Cap Growth Equity Composite will perform in the future.

This performance information gives some indication of the risks of an investment in the US Small Cap Growth Equity Composite. Performance figures for the period ended shown herein represent a composite of fully discretionary, fee-paying SAM equity accounts above \$5,000,000. The composite is size weighted and includes terminated accounts through their last full month under management. The returns presented reflect the reinvestment of dividends and other earnings. Beginning September 17, 2007, composite policy requires the temporary removal of any portfolio incurring a client-initiated significant cash inflow or outflow of 10% or more of portfolio assets. This will cause the account to be removed for the month in which the large inflow or outflow occurred. The account will be re-included in the composite the month following the large inflow or outflow. Sparta Asset Management, LLC will document the date of the cash inflow or outflow, date the account is removed, and date the account is re-included. Sparta Asset Management, LLC will also document the amount of the inflow and outflow and identify if it is a contribution or withdrawal from the portfolio. Additional information regarding the treatment of significant cash flows is available upon request. US dollars are the currency used to express performance. There is no guarantee that the portfolio manager will achieve similar results in the future. Please refer to the Sparta Asset Management, LLC Form ADV Part II for a full disclosure of the fee schedule and other detailed information regarding the services offered. The returns presented have sustained significant gains and losses due to market volatility.

### Index Information

The Russell 2000 Index is a market value weighted index of the 2000 smallest US companies in the Russell 3000 Index, which includes 3000 of the biggest US stocks. The Russell 2000 Growth Index consists of those Russell 2000 companies with higher price-to-book and higher forecasted growth values. The volatility of the indices may be materially different from the individual performance attained by a specific investor. In addition, Adviser's holdings may differ significantly from the securities that comprise the indices. The indices have not been selected to represent an appropriate benchmark to compare an investor's performance, but rather are disclosed to allow for comparison of the investor's performance to that of certain well-known and widely recognized indices. You cannot invest directly in an index.

COMPOSITE PERFORMANCE							
COMPOSITE ASSETS			ANNUAL PERFORMANCE RESULTS				
YEAR END	TOTAL FIRM ASSETS (THOUSANDS)	USD (THOUSANDS)	NUMBER OF ACCOUNTS	COMPOSITE GROSS	COMPOSITE NET	RUSSELL 2000 GROWTH	COMPOSITE DISPERSION
2008	226,053	171,246	9	-38.75%	-39.45%	-38.54%	n.a.
2007	166,885	90,195	five or fewer	3.00%	2.03%	7.05%	n.a.
2006	n.a.*	74,211	five or fewer	14.96%	13.98%	13.35%	n.a.
2005	n.a.*	1,251	five or fewer	10.73%	9.63%	4.15%	n.a.
2004	n.a.*	11,160	43	18.41%	16.81%	14.31%	0.43%
2003	n.a.*	6,159	24	55.71%	53.44%	48.54%	0.96%
2002	n.a.*	2,639	12	(12.51%)	(14.04%)	(30.26%)	0.66%
2001	n.a.*	3,388	15	(5.68%)	(7.33%)	(9.23%)	0.96%
2000	n.a.*	4,011	20	11.21%	9.40%	(22.43%)	3.94%
1999	n.a.*	2,807	12	74.75%	72.18%	43.09%	n.a.
1998	n.a.*	941	five or fewer	(3.75%)	(5.40%)	1.23%	n.a.
1997	n.a.*	742	five or fewer	22.89%	20.76%	12.95%	n.a.
1996	n.a.*	245	five or fewer	31.38%	29.09%	11.26%	n.a.
1995	n.a.*	108	five or fewer	—	—	—	—

n.a.\* Total firm assets were from a prior firm. See important disclosures about this performance information herein.

n.a. -Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year.

