



## The Market

*“We have had a bad banking situation. Some of our bankers had shown themselves either incompetent or dishonest in their handling of the peoples funds. They had used the money entrusted them in speculations and unwise loans. This was, of course, not true in the vast majority of our banks, but it was true in enough of them to shock the people of the United States into a sense of insecurity. And so it became the government’s job to straighten out this situation and do it as quickly as possible. After all, there is an element in the readjustment of our financial system more important than currency, more important than gold and that is the confidence of the people themselves. Confidence and courage are the essentials of success in carrying out our plan. You people must have faith; you must not be stampeded by rumors or guesses. Let us unite in banishing fear. We have provided the machinery to restore our financial system, and it is up to you to support and make it work” –Franklin Delano Roosevelt – 12 March 1933*

This quote from 75-years ago fairly sums up the past 18-months as well as it did in 1933. While 2008 will be remembered as one of the worst financial markets in history for all markets including the small cap area we invest, we believe there are many longer-term positives to take from this recent decline since much of the excesses have now been purged from the overall system.

As we mentioned during the first part of the year, one of the primary issues in the markets has been liquidity and leverage. We began to see this over a year ago, and focused our investments even more on owning companies with good growing cash-flows, lots of cash on their balance sheets, and sound business models with limited needs for debt or lines of credit from a bank to run their businesses. Let me take an excerpt from our Q1/2008 Commentary:

*“In today’s credit crisis, if you need to rely on debt or a line of credit to continue managing your business you may be in for a difficult time. If a company needs to access this credit window at just the wrong time, it may put the entire enterprise in jeopardy. Whereas, if a company is able to run and manage their growing business without debt, they can weather these uncertain times much better.”*

We continue to find our portfolios in the latter camp and have been for most of 2008, and while it has not stopped the underlying stock prices from going lower, we believe that owning profitable, cash rich companies at a time like this is of paramount importance as they will be some of the first to see a recovery.

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## Volatility and Risk

The volatility during Q4/2008 was unprecedented. The returns in the markets during 2008 and most notably during the fourth quarter were driven primarily by larger macroeconomic issues which forced massive deleveraging throughout the system as participants were less focused on individual stock selection and more focused on reducing their overall exposure to all equities. A common measurement for volatility in the stock market is the Volatility Index, or “VIX”, which measures the overall volatility of options tied to the top 100 stocks in the US markets. This index is a good representation for the overall level of volatility but is difficult to put into perspective for how the average stock performed on a daily, weekly, or monthly basis which is why we decided to run our own study measuring the daily volatility of the Russell 2000 Growth index over the past 10-years. Some investors view volatility as a measurement of risk, while others would say that volatility creates opportunities.

The fourth quarter offered a little bit of both. According to our study, the Russell 2000 Growth index moved from high-to-low each day an average of 5.84%! On a monthly basis the moves were as follows: October {7.08%}, November {5.55%}, and December {4.88%}. This took into account days when the market moved down (-3%) in the morning only to finish the day up +3% later, or vice versa, for an overall move of 6% that day. To put this into perspective, according to Russell investments, the average yearly return of this same index over the past 10-years had been +4.67% per year through Q3/2008. These are violent and irrational moves for an index of 1300 total stocks. Even the bursting of the internet bubble in the Nasdaq during the year 2000 only had a daily average move of 3.58%, and the terrible events after September 11th, 2001 had a daily average reading of only 2.91% (for 9/17/01-10/31/01), both more than 40% less volatile than the last 4 months of 2008.

During the fourth quarter, and most of 2008, this volatility was driven more by uncertainty, panic, short-term trading and deleveraging and less by fundamental bottom-up research, which puts a rational value on the current and future growth prospects of a company. If a stock is the proxy for the underlying company, I think most investors would agree that a company's underlying business is not this volatile in any given day, week, or month, but their stock prices were incredibly volatile during most of the fourth quarter. In our minds, the returns during this period are only a snapshot of the day's final volatility and not fundamentally based relative to the underlying business. The wild short-term swings in all markets have caused Investors to take on a "Trader mentality" when assessing all of their investments. It has not been a big secret that the US economy is slowing. The question on everyone's mind today is: "How much will it slow?" Unless your company is highly leveraged with no margin for error then it shouldn't matter. Is it fair to assume that because one company's profits will not grow over the next quarter then the overall businesses and enterprise should be valued at zero? This is happening every day in the market. The stock in many of these types of companies may very well be worth nothing if they must rely on debt to fund their daily operations since they must first pay off the debt before shareholders receive anything. These companies have caught all the headlines and caused tremendous volatility and perceived uncertainty within the capital markets as investors now question every aspect of the stocks they own. On the other hand, there are many other companies with zero debt, a highly profitable long-term growing business and have upwards of 40-50% even 100% of their entire market values in cash which is being overlooked during these uncertain times. We believe that none of these recent events are terminal for the vast majority of small cap and emerging growth companies where we invest, but instead has only caused a temporary delay in their future growth trajectory.

## The Portfolio

The fourth quarter of 2008 was the final crescendo to a very difficult year as the Russell 2000 Growth index dropped by -27.45% to finish its worst year on record. Over our 13-year history of managing small cap assets, the market of 2008 was quite different in that there were very few places to hide as the macro events and deleveraging overshadowed everything else. Unlike the technology bubble where a select sector within the growth universe became wildly over-priced and many investors including ourselves were able to move away from those areas and find reasonably priced growth companies in other sectors, 2008 was a different story. As a diversified manager, we tend to hold a minimum of 6 sectors within the index. On the top of the next page is a table showing how each sector of the Russell 2000 Growth index performed and their corresponding weighting within the index over the course of the year.

The Consumer Discretionary, Healthcare, Industrials, and Information Technology sectors have always made up the bulk of the growth universe. These four sectors accounted for 77% of the entire weighting in the index and the best performing sector of those four, Healthcare, still lost (-30.47%). Like most growth managers we tend to be more heavily concentrated in these four main sectors and this year was no different.

	Russell 2000G Average Weight 1/1/08 - 12/31/08	Russell 2000G Return 1/1/08 - 12/31/08
Consumer Discretionary	13.4%	-42.16%
Consumer Staples	2.33%	-19.99%
Energy	6.82%	-46.21%
Financials	6.87%	-27.97%
Healthcare	22.78%	-30.47%
Industrials	19.98%	-39.55%
Information Technology	21.5%	-42.84%
Materials	3.95%	-51.28%
Telecom Services	1.52%	-49.49%

Source: FactSet

For over 13-years we have always prided ourselves as bottom-up stock pickers who focus on owning a meaningful position in the best names we can find in the market. As a whole, we did fairly well across the board. For example, our positions in Industrials did relatively well during the year declining on average only **(-7.42%)** versus a **(-39.55%)** for the sector as a whole. Also, in a year which was very difficult for most retailing companies, our underweight stance in the Consumer Discretionary names fell on average **(-30.1%)** versus **(-42.16%)** for the index. The one main detractor for the year was in the technology sector, which took the brunt of the overall market's decline and had an over-weight position during the year. During Q4 our Technology positions performed better than the market as a whole but still underperformed for the year. Our performance in 2008 had a lot to do with the overall markets and to some extent was due to an overweight position in a few long-term technology favorites in the portfolio. As we have discussed throughout the year, the bulk of these detractors are still alive in our portfolio and we do not believe have any terminal issues. Different than attempting to determine how a company like General Motors (which is technically a small cap now), will grow or survive in the future, a few of the individual companies in our portfolios which had above average negative contribution are still positioned extremely well in their respective markets for future growth even though their current share prices may reflect otherwise.

Throughout 2008, the Technology sector was an area of focus for us due to the increased penetration of small form factor, consumer, and wireless technological innovations around the world along with extremely strong balance sheets relative to their size. When all the talk in the press is about the credit crisis and companies needing a bailout, the technology sector in many ways has what we feel is the risk/reward profile investors are looking for. We believe what hurt us during the year had more to do with the near-term macro-environment and temporary slowdown in the markets where many of these new products are sold, and much less to do with the quality and competitive advantages the companies we own possess over the slightly longer-term. For example, we have positioned in companies who should benefit from the next generation of laptop computers. Early in the year we began to see many different designs utilizing LED technology to power the screens as well as embedding cameras into the laptops themselves. This technology is making the overall size of the computer very thin, light-weight and will use 30% less power than the existing laptops thus saving power and extending battery life. By the end of 2008 we now see all the major laptop vendors with models utilizing this technology, with many planning on upgrading all of their models in the future. This type of technology shift is one where we have participated in the past, and during 2008 continued to position our portfolios into the small cap technology leaders benefiting from these exciting trends. The wildcard in 2008 was the timing by the end customer. As we know, the consumer was very weak in 2008 and had a near-term negative impact on the overall level of sales of consumer electronics and with it laptops and other new technology products. But, this has not stopped the PC vendors from shifting to these new technologies across the board. We believe it is more important to be positioned in front



of these secular technology shifts and own the companies who are most levered to these trends as they are mainstream. Many of the stocks are the component suppliers to these end customers and are healthy companies with no debt and a tremendous amount of cash to weather any storm and whose stock prices are now trading at the level of cash sitting on their balance sheets and thus the markets are pricing their entire businesses at zero. Ultimately, the consumer and business purchasers will return and we believe these companies will once again be the most well positioned to continue to participate in this secular growth.

## Outlook

As we look into 2009 and beyond we feel the current historically low valuation levels of small-cap stocks coupled with unique, niche business models, very low expectations, lower commodity prices and all-time low interest rates has laid the groundwork for a very attractive equity market going forward. During times like this when “Cash-is-King”, the companies with strong and flexible balance sheets can take advantage of these situations and take market share while their overly-levered competitors continue to stagnate. Currently these same cash-rich growth companies are being thrown out along with everything else in the market due to many of the forces described above and also due to the short-sighted nature of this “instant-gratification” market we find ourselves in. While this journey will not be a quick trip back to new highs in the market, we feel the current environment has all the hallmarks of being one of those ‘once in a generation’ events to own stocks and most specifically the under-leveraged small-cap variety we favor. When Treasury yields went negative for short-term government bonds during the fourth quarter, it was a signal to us that we were very close to the end of this recent panic.

We believe 2009 will be a more stable, albeit difficult, macro environment and thus participants will once again begin focusing on stock selection as an investment discipline. We firmly believe quality and fundamentals drive stock prices over the long-term. The last few quarters have shown that we are not immune to the short-term gyrations of the market; however, it is our opinion that the markets have overly discounted the future prospects of our holdings without regard for the underlying longer-term strength of these businesses. For example, at the end of the year the average company in our portfolio has over 15% of their market value in net-cash. Further, in the largest sector we hold, Technology, the average company has nearly 40% of their total market value in cash and holds no debt. The chart below shows the comparison of our portfolio versus the Russell 2000 Growth Index. We continue to work diligently and look at market fluctuations as our friend rather than our enemy in order to profit from the folly of others so we may benefit. As always, we assure you that our focus is singular and our efforts vigilant during this difficult market environment. Thank you again for your continued support and confidence.

Net Cash as a % of Total Market Value 12/31/08		
	Russell 2000 Growth Index	Sparta Asset Management
Consumer Retail	-31.04%	12.02%
Consumer Staples	-39.38%	-10.86%
Energy	-68.74%	-4.94%
Financials	-47.90%	14.87%
Healthcare	0%	20.85%
Industrials	-34.5%	5.24%
Information Technology	8.54%	38.23%
Materials	-62.54%	-39.96%
Telecom Services	-104.51%	58.9%
Utilities	-62.1%	N/A
<b>TOTALS</b>	<b>-27.29%</b>	<b>15.23%</b>

Source: Factset/Baseline

## U.S. SMALL CAP 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 SAM 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 SAM 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 SAM 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. 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.

