



The Market

The very challenging end to 2007 has continued in early 2008. The first 14 trading days of the year seemed to set the tone for the entire first quarter. Table 1 to the right is a snapshot of returns from intra-day high to low for different market indexes during this period.

Statistically, this period represents one of the worst starts to a year since the 1930's and has all the earmarks of a classic de-leveraging panic. Nearly every market pundit and investment expert in the country has traded opinions on the health of our economy and reasons for the decline of the markets over the last year. While there may be a multitude of causes and explanations for this current downturn, we will focus this commentary on the three key drivers we feel explain it best from our view.

THE MISPRICING OF RISK

Much talk of the current market woes has surrounded the "Sub-Prime" mortgage collapse. Problem is, we have always had sub-prime borrowers in the economy. In the past, however, lenders would give their best and strongest customers the best rate (Prime) and their less credit-worthy customers much higher rates (Prime + a margin). This axiom was primarily due to the fact that the bank would hold the loan on their books and receive payments from the borrower over time. Banks would generally want independent verification of income, assets, and appraisal values since it was the banks' money that was ultimately at risk. This is precisely where everything changed.

Over the past few years, many private-equity firms, companies, and individuals across the U.S. felt entitled to be a "Prime" borrower, and many investment bankers, real estate agents and mortgage brokers did what they could to make sure they could fit a square-peg into a round hole. The traditional risk premium was completely ignored in favor of a fee-paying, volume lending frenzy. And here's why...

During this historic period of declining interest rates, low delinquency rates and tightening spreads for all borrowers, the business of lending became extremely competitive. Through a combination of rising stock prices, increasing wages, and rising home values, the U.S. consumer was experiencing an increase in their overall wealth unlike any time in history. Mortgage lenders and banks competed furiously to capture the rising appetite of U.S. consumers for loans of all kinds. The only way to

compete was to do more volume than the next guy OR... come up with new and different products. Along came interest-only, adjustable-rate, reverse mortgages and the like. But how was the risk in all of these loans being priced? Surely not all loans would cost the same, with no regard for credit-worthiness or one's ability to pay. Wrong! It didn't matter as long as these lenders continued to churn out loans. Why? Because they were not holding any of these loans on their own books. They were re-selling the loans to Wall Streets' financial institutions and other larger banks (Seen the name change on your mortgage statement lately?).

During this same period of historic growth in personal wealth and low interest rates, Wall Street saw an opportunity to meet a new demand. Investors (especially institutional investors) were hungry for better yields on their fixed-income portfolios which amounted to a significant portion of their total assets. They couldn't afford to abandon this historically less-risky asset class entirely in favor of the lure of returns in alternative investment products (hedge funds, private equity, etc.). But they needed to improve on their fixed-income returns if they were to meet their long-term obligations. So, Wall Street stepped in by offering a new type of investment vehicle. Bank loan products such as Commercial Debt Obligations (CDOs) and Commercial Mortgage Obligations (CMOs) were created as large pools of loans combined to achieve a greater rate of return than traditional core fixed-income securities (corporate loans, treasuries).

The thinking was, by pooling these huge blocks of mortgage loans in with other more conservative debt instruments, the overall risk of the portfolio

RETURN INTRA-DAY HIGH TO LOW

	1/1 - 1/22/08 Return
CRB Commodity	-1.4%
Dow Jones Industrials	-12.4%
S&P 500	-13.4%
S&P Midcap	-14.9%
Russell 2000	-15.4%
Nasdaq Composite	-16.5%
Russell 2000 Growth	-19.5%

TABLE 1

Source: Baseline



would be spread out. Sure, there would be some defaults on these loans, but not enough to significantly impact the entire pool. Only one little problem- the proud new owners of these loans (Bear Stearns, UBS, Merrill Lynch, to name a few) had no idea how the loans were originated. What was the process for verifying borrowers' income, assets, creditworthiness, etc. when these loans were first made? They purchased these loans from lenders (mortgage brokers, banks) without ever correctly pricing the risk of the loans. You can begin to see the storm clouds forming.

THE LIQUIDITY CRISIS

Housing prices begin to fall...gas prices skyrocket...food (commodities) prices continue to rise. Homeowners, who were enticed by the low payments of adjustable-rate mortgages, saw their loan period run out and higher rates kick in. The U.S. consumer was over-leveraged and began to tighten their belts. Default rates on mortgages and home-equity loans began to rise, late payments on credit cards increased, and consumer discretionary spending slowed. However, what has ensued is not a solvency crisis- the whole country is not going broke. It's a liquidity crisis. Money is being held back by consumers, lenders and investors as they fear the safety of these volatile, uncertain markets.

For the institutional investor, it goes even further. The securities we mentioned above (CMOs, CDOs, etc.) do not trade daily (or weekly for that matter) in the public markets. So how are the big financial firms that hold this debt going to sell it off and reclaim their balance sheets? Well, if you can't sell what you need to sell, you sell what you can...at any price. So, we've seen a mechanical unwinding of this debt over the last two quarters with firms selling off their equities regardless of the individual companies' fundamentals or valuations. Fortunately, the Fed has recently stepped in with the creation of the Term Auction Facility (TAF) and the Term Securities Lending Facility (TSLF). These facilities are designed to allow banks and broker-dealers the ability to exchange their illiquid mortgage-backed securities for U.S. Treasury securities.

THE UPTICK RULE

While cooler-heads are beginning to prevail as we enter the second quarter, much damage has already been inflicted for equity prices in the broad market since the market peaked in July of 2007. Curiously, a little known change to the way stocks can be traded was eliminated in that same month. Back in the 1930's, the "Uptick Rule" was established in order to prevent aggressive short-sellers from creating a panic in a stock(s) and ultimately, the market as a whole. The rule

prohibits an investor from shorting a stock while its price is dropping. You can only short a stock on an "uptick" of its price.

Through aggressive lobbying on the part of broker-dealers and Wall Street Traders (seeking increased trading revenues I suspect), regulators removed this "uptick" restriction in July of last year. Short-sellers have taken advantage of this recent rule change by ganging up on stocks that they have projected to fall in price by short-selling it on the way down. We believe, as do many others in the industry, this slight change in the way stocks can be traded has created undue volatility in the markets which are most pronounced for the small-cap companies we invest in on a daily basis. This is why we believe it is more important than ever to have an investment strategy which focuses on buying "companies" and not just pieces of paper which trade on a stock market. While we cannot predict how others will value our companies on a daily, weekly, or monthly basis, we do know that over longer periods of time stock prices follow the underlying growth and fundamentals of the business. We have and always will buy stocks based on how we value the business and growth prospects today and in the future. Today, the market pessimism and downside volatility is creating some of the best opportunities to buy stocks of individual small cap companies since the end of the last recession of 2002.

THE PORTFOLIO

The market conditions and environment the last half of 2007 and early 2008 represented a major contradiction to our core philosophy as a fundamental institutional money manager. For 12 years, we have built a track record based on a vigilant discipline of knowing the companies we own and paying only rational prices for their growth. This philosophy is further driven by the objectives of our clients. We are singularly focused on the long-term growth of assets for our institutional clients. We are not influenced or wavered by short-term market conditions that could tempt us to deviate from this discipline.

During the first quarter, the Russell 2000 Growth index continued to exhibit extremely volatile readings over a very short period of time. In fact, of the 65 total trading days, there were 48 days when the index moved 2% or more in a single session! Those are fairly extreme readings and I think most investors would agree that a company's underlying business is not that volatile in any given day, week, or month. In our minds, the returns during this period are only a snapshot of the final day's volatility and not fundamentally based relative to the underlying businesses. Good stock selection in both groups, as well as Industrials and Materials allowed us to show gains in all these sectors versus the index for the quarter.



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NET CASH AS A % OF TOTAL MARKET VALUE

	R2000G	Sparta
Consumer Retail	-29.3	+14.8
Consumer Staples	-19.1	-44.2
Energy	-21.5	-4.2
Financials	-70.3	-16.0
Healthcare	-.20	+18.4
Industrials	-17.7	+1.6
Information Technology	+7.4	+23.8
Materials	-70.5	+9.2
Telecom Services	-30.3	+37.2
Utilities	-29.3	N/A

TABLE 2

Source: FactSet

PERFORMANCE

In times of economic uncertainty, the traditionally defensive sectors of Healthcare and Telecom Services tend to be where investors flock. Again, the markets had their own set of rules in the first quarter as these two sectors were two of the worst performing sectors in the Russell 2000 Growth index for the quarter, while Energy was the only sector to register a gain for the index. Our portfolios had been overweight the Energy sector and Telecom Services heading into the quarter. The portfolio enjoyed success in Energy, Telecom Services, Industrials and Materials.

The main source for the slight underperformance in the quarter was our overweight stance in Information Technology. While our stocks selection was on par with the index (our stocks went down equally as much), we are more heavily weighted toward this group than the benchmark. We are undeterred in our view that Technology is one of the best areas for outsized returns and less risk in this current market environment. Please see Table 2 at the right, showing the amount of Net Cash on the balance sheets of the average companies in each sector of the Russell 2000 Growth Index, versus the Sparta portfolio at the end of the quarter.

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 very 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. In the short-term, market participants recall the last down draft we had in the markets back in the years 2000-2002 and Technology led the way down. This memory is still fresh in investors' minds and has led them to flee technology companies even though we believe it is unjustified this time around. The past market cycle had extremely high valuations, coupled with a promise of a technology revolution. Recall, promises of High-speed connectivity, small form factor computing, ubiquitous wireless connectivity...etc were all the rage and hype back in those times. Today, those technologies are actually here, growing rapidly, and are becoming mainstream not just in the U.S. but all over the world. Current valuations of technology companies are only a fraction of what they were during the last market cycle while the total addressable market and penetration for these products are many times as large as they were then. We believe this is one of the best opportunities in recent memory to own attractively priced companies in a rapidly growing sector.

OUR VIEW

We believe that the indexing phenomenon and flock to larger capitalization companies, just for the sake of how liquid their company's stock is on any given day, is coming to an end. The Fed has taken unprecedented steps during the credit crisis to help the financial system where it's needed the most. Today, they are signaling to the markets that its time to start making investments again. With money market funds yielding just 2%, it is time to begin investing in areas which will generate higher returns. Today, the balance sheets and business models for many of the traditional growth sectors of the economy couldn't be stronger, and at the same time, current prices in the market for the vast majority of these companies has already priced in a catastrophic slowdown due to these credit concerns. We believe these concerns are overblown.

The beginning of each year is also the time when companies discuss their final results of the last year and at the same time start discussing how they view the year ahead. Most seasoned management teams understand the value of under-promising and over-delivering in the post Sarbanes-Oxley world. They set the stage for the year ahead and look at the current analyst expectations and, where appropriate, look to temper expectations so shareholders are rewarded in the future periods. This is called the "expectations game" and everyone today plays it. 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 emotional gyrations of the markets. However, it's our opinion that the markets have overly discounted the future prospects of many of our holdings without any regard for the underlying fundamentals of these businesses. For example, at the end of the quarter the current companies we hold in the portfolio have over 16% of their total market value in cash and short-term investments and in many cases hold no debt. At the same time, earnings for these same companies are expected to grow +27.5% over the next 12-months while the current P/E ratio we are paying for that future growth is only 14.6x those forward earnings expectations. We believe that in the current market environment where investors are only focused on the very short-term, they have lost sight of the fact that stocks are in-fact shares in a company where business decisions are made for years not weeks. This instant gratification market environment has created wonderful opportunities to take advantage of this disconnect. As Warren Buffet said, "Look at market fluctuations as your friend rather than your enemy: profit from the folly rather than participate in it". We couldn't agree more and as always we assure you that our focus is singular and our efforts vigilant. Thank you for your continued confidence and support.



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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 \$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.

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. 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 the gross performance was reduced by transaction costs. 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 \$250,000. 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. An index is unmanaged and is not available for direct investment.

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
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	—	—	—	—



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