



*"I, however, place the economy among the first and most important virtues, and public debt as the greatest of the dangers to be feared,"*  
*(Thomas Jefferson).*

### **THE MARKET**

- The 3rd quarter of 2011 was extremely volatile and small cap stocks took the brunt of the market volatility. The Russell 2000 Growth index declined (-22.25%) in Q3 2011, its worst quarterly performance since Q4 2008 and the 4th worst quarterly return since 1995.
- Macro headlines throughout the world continued to drive the daily trading of most assets during the quarter. New trading vehicles took center stage during the 3rd quarter as total volume surged within these financial products (ETFs) with little regard to the impact these vehicles are having on the underlying baskets of securities that these funds actually represent.
- The average daily volatility of the small-cap market approached levels not seen since the market lows of Q1 2009. During the month of August 2011, the average daily volatility of the Russell 2000 Growth Index was greater than 4% per day with several days registering over 7%! To put this in perspective, the average return over the past 7-years for the Russell 2000 Growth index has been +3.93% per year.
- The completion of the second round of government monetary intervention (QE2) on June 30th caused investors to realize that QE2 had a much greater impact on asset prices than on the underlying economy as it was originally intended. The recent dramatic correction appears to have brought asset prices back down to levels that more adequately reflect the reality of the slow-growth environment we have actually been in since the trough in 2009.
- During the 3rd quarter, markets were shaken by a series of macro and government uncertainties. Most notably, Standard and Poor's decision to downgrade the credit rating of the U.S. Government on the heels of the government debate surrounding a rise in the U.S. debt ceiling caused markets worldwide to plunge. Once this downgrade took place, investors began to question the creditworthiness of many other countries around the world causing central bankers to attempt stabilizing markets through even more short-term intervention.
- Major economic indicators like employment, industrial production, housing and negative GDP revisions remind us that this is an anemic, slow recovery.
- Although the M&A markets were fairly quiet during the market turmoil, our portfolio was the beneficiary of one acquisition early in Q3.
- Best performing sectors (R2000G) in Q3: Utilities (-7.2%) and Consumer Staples (-7.4%). Investors sought the shelter of the more defensive sectors and those with high dividend yields.
- Worst performing sector (R2000G) in Q3: Energy (-32.9%). The price of oil dropped by another (-16.2%) from July 1st through September 30th on top of the (-11.3%) in the 2nd quarter due to continued modest demand from a slow-growth economy combined with new sources of domestic supply from developing shale regions.

### **PORTFOLIO REVIEW**

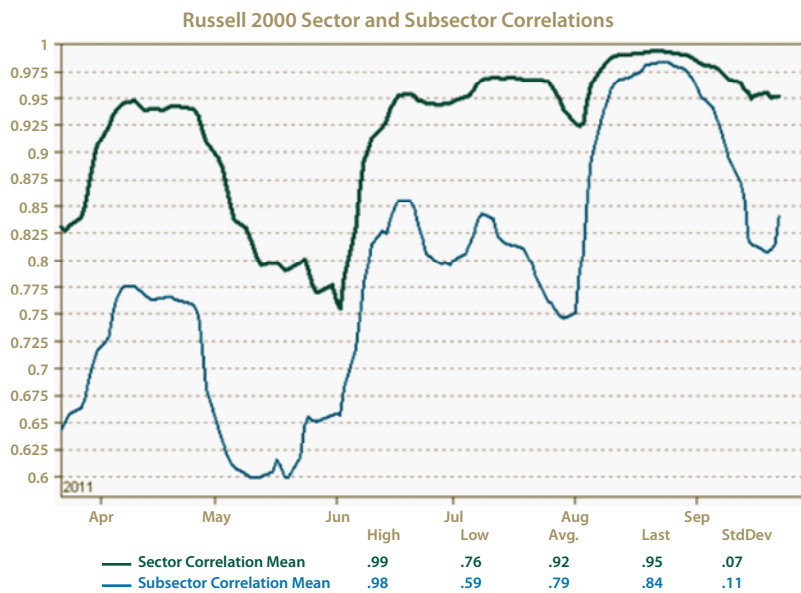
- The U.S. Small Cap Growth Equity composite return for the quarter was -20.60% gross of fees (-20.81% net of fees) vs. -22.25% for the Russell 2000 Growth Index (important disclosures about this performance can be found on page 6).
- During the quarter we remained underweight consumer discretionary but outperformed the group due to positive performance from a large holding. Same store sales and margins continue to show improvement at this company as

initiatives taken to turn around the company continue to unfold. Due to the strong balance sheet the company bought back 10% of their outstanding shares in Q2 which will benefit future EPS.

- We were slightly underweight in the Healthcare Sector and overall our selections marginally underperformed. Our pharmaceutical and healthcare services selections performed well relative to their benchmark counterparts. Our pharmaceutical selections continue to favor smaller, well-capitalized drug development companies whose positive cash flow streams are utilized to fund their development pipelines. Our healthcare services positions focused on companies that not only have steady volumes with core business but also take market share through innovative new offerings. We also favor prescription benefit managers that gain additional margin via switch to generic vs. branded offerings - a trend we see gaining traction as the branded drug patent expirations accelerate in the fourth quarter and beyond. Our performance was hurt by our Healthcare Equipment companies which suffered from weakening hospital budgets as they deal with a payer mix shift from private pay to more Medicare and Medicaid.
- We were overweight Industrials during the quarter as we continue to find solid opportunities within this group. While our performance in this sector was only in-line this quarter we believe many of our stocks here got hit even though they're less directly affected than others by weak economic growth and other macro concerns. Our best performing industry group on a relative basis was industrial machinery where companies supply equipment to more robust end markets like the oil and gas industry, agricultural markets, and the electric utility industry that is seeing renewed investment to accommodate alternative energy sources being applied to the grid. Furthermore, these companies are benefitting from international expansion to higher growth emerging economies.
- Performance was negatively impacted by the fact that we had no exposure to Consumer Staples which was one of the best performing sectors this quarter being down only -7.4%. Investors are willing to pay a premium for safety in today's volatile market and as a result have driven valuations in this sector to unsustainably high levels. We have always focused first on a company's growth, then secondarily on what are we paying for that growth and thus we have been unable to rationally justify initiating new positions in this sector at this time.
- The Materials Sector was our second worst performing sector which we were overweight. Our largest investment in this sector is a leading manufacturer of advanced materials and chemistries for applications such as rechargeable batteries, lead-free electronics, cutting tools, industrial coatings for aerospace applications, and medical devices. Concern over a slowdown in some of their end markets primarily in Europe and Asia caused short-term investors to sell. We feel that the long term prospects could not be better for this company and have used this sell-off to add to our position.
- Our largest overweight remains Information Technology which had a slight negative contribution to our performance this quarter. The hardest hit industry group was semiconductors which were down -32% for the quarter. We have been bullish on semiconductors and the semiconductor capital equipment cycle due to the underinvestment during the economic downturn and the expanded 2011 budget forecasts announced at the beginning of the year by many of the largest semiconductor manufacturers and foundries. In addition to underinvestment in more traditional areas of semiconductor manufacturing like processors and memory, new sources of demand are growing rapidly like LED semiconductors for wide-ranging applications like televisions, notebook computers, tablet computers, mobile phones, industrial applications and the coming general lighting boom. The overwhelming advantage of LED's due to smaller form factor and dramatically lower power consumption is driving rapid adoption in these areas. The hardest hit semiconductor materials company in our portfolio was down -35% for the quarter despite the fact that they remain very well positioned to take advantage of trends developing in this space. The company has 40% of its market cap in cash, is on track to earn \$1.82 up from the \$1.24 it earned in 2010 (+50%) and at the end of the quarter it was trading at 4X EV/EPS. We view this and other similar short term price dislocations in the semiconductor group as an opportunity to add to our positions.
- Our best performing sector was Energy where we benefitted from smaller oil and gas producers that focus on the newly

discovered prolific shale regions domestically. Our best performing selection in this group has been able to grow its production by over 40% year over year thanks to successful application of new technology to its finding, drilling and completion techniques.

- Correlations between asset classes and individual stocks continue to be elevated. Investors seem to be taking an ALL or NONE approach to economic sectors (see chart below). The rise in the use of Exchange Traded Funds (ETFs) have made it very easy for traders to get in and out of select sub-sectors of the economy with little regard to the impact of the underlying securities. As investors pile in and out of these new “trading vehicles”, behind the scenes, the buying and selling pressure of the individual companies represented within these ETF baskets is indiscriminant. ETF buyers and sellers inadvertently buy/sell certain stocks for no apparent fundamental reason other than the fact that they are constituents within a select ETF. There’s no distinction about fundamentals and it’s fair to say that it’s improbable that all the holdings within the index should be worthy of purchase at any given time. Similarly, it seems unlikely that every holding within a select ETF should be fundamentally sold short at one time either. However, when investors buy and sell ETFs in the open market they are leaving a large footprint which in turn creates a self-fulfilling prophecy across the market as money flows move in and out of the underlying securities. The waves of volume being driven by these ETFs today into the underlying securities are staggering. The sole motivation is to blindly buy or sell the entire basket of securities the ETF represents based on the money-flow in the ETF at any given point during the day, and does not discriminate between good or bad companies, only how much weight a particular ticker symbol represents within the index. Assets under management for ETFs have skyrocketed to approximately \$1.1 Trillion as of August 2011 and the total daily volume of ETFs is over 30% of all US stock volume.



Source: Goldman Sachs

**OUTLOOK**

We continue to characterize the U.S. economy as one of slow-growth with unemployment remaining persistently high at least through the intermediate term. The second round of government intervention (QE2) that ended in June 2011 had a much

greater impact on asset prices than the underlying economy as it was originally intended. The recent dramatic correction appears to have brought asset prices back down to the level that more adequately reflects the reality of the slow-growth environment we have actually been in since the trough in 2009. Estimates for GDP growth have been ratcheted down for two quarters in a row to 1% on average for the remainder of 2011. The unemployment rate at 8.8% in Q1 2011, 9.2% in Q2, and 9.1% as we exited the third quarter is further evidence of the challenges the economy faces and is the primary reason we have been under-weight the Consumer Discretionary sector for nearly 3 years and will continue to be very selective in this area going forward until we see real improvement in the U.S. jobs data.

Over the past year, we postulated that the biggest risk to asset prices would be the end of the US government's monetary intervention QE2. Most investors finally realize that QE2 had a much greater impact on inflating asset prices and had little effect on the underlying economy. The original intention of the \$600 billion quantitative easing was to help stimulate the economy and create jobs, but during the third quarter of 2011 investors around the world came to the realization that this entire monetary stimulus had only served to push equity prices beyond rational values when compared to the underlying business fundamentals. The completion of this program marked the end of the Fed induced speculative period.

We believe the best opportunities will continue to be in defensive growth companies that have high barriers to entry, rock-solid balance sheets, unique products and business models that allow them to take market share from competitors, along with technological leadership to serve emerging economies which are less reliant on the U.S. consumer. We continue to concentrate our efforts on companies with strong secular growth prospects in areas less directly affected by hopes of a cyclical economic recovery. Some areas of focus include domestic shale oil development, long haul electrical transmission construction, agriculture related spending, healthcare I.T. infrastructure, and new technologies such as HD video and LED technology adoption.

One of the more interesting contradictions that fundamental investors face is that the outlook from corporate executives is much brighter compared to the market's gloom. However, this stems more from current positioning than a particularly rosy outlook for the economy. Corporate balance sheets are very strong, inventories are light, organizational structures are very lean with streamlined supply chains, and abundant acquisition candidates are available at reasonable prices. Most management teams are optimistic that current levels of demand are sustainable while input costs of raw materials continue to decline. The Federal Reserve reported on September 16, 2011 that corporate cash balances grew to a record \$2.05 trillion – a 4.5% increase over last quarter. However, corporations are earning next to nothing on this cash with short term treasuries yielding less than 0.25%. Despite lobbying from the President, short term tax incentives and protests in the streets, corporate leaders are determined to pursue endeavors that build shareholder value. Companies appear unwillingly to use this cash to expand their own facilities, grow headcount, or other initiatives that will increase their expenses in the face of a slow, anemic demand environment and government uncertainty. Instead, the main use of cash has been for acquisitions which offer immediate, lower risk returns on capital. To date, worldwide M&A deal volume has risen more than 25% on the year to 1.94 trillion, according to Thomson Reuter's data.

As we enter the 4th quarter, markets continue to be dominated by a barrage of positive and negative news-flows coming from the many central bankers and governments around the world as they attempt to find answers to their debt woes. These turbulent markets have created a tremendous opportunity for longer-term, bottom-up growth managers like us. We remain focused on knowing what the growth drivers are for all of our companies, having a deep understanding of what makes a

company tick, why we own it and what the real economic value is relative to future growth. With that, we have a number of significant event-driven positions that have upside catalyst and economic tailwinds which are independent from the current macro environment. We continue to build a dynamic portfolio, of well run small-cap growth companies that trade at a discount to the future growth prospects. While we cannot predict how other market participants and forces will value our companies on a daily, monthly or quarterly basis, we feel our portfolio of fundamental growth companies trading at rational valuations give us a margin of safety in this erratic environment.

As always, we assure you that our focus is singular and our efforts vigilant. Thank you for your continued 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<sup>®</sup>).

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

Sparta Asset Management, LLC has been GIPS verified for the periods September 17, 2007 through June 30, 2011 by Ashland Partners & Company LLP. A copy of the verification report is available upon request. In addition, a composite specific performance examination has been conducted on the US Small Cap Growth Equity Composite beginning September 17, 2007. The period October 1, 1995 through September 14, 2007 represents the equity portfolio track record established by the Portfolio Manager while affiliated with a prior firm. Ashland has reviewed this track record for compliance with the portability requirements of GIPS standards.

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. During this period gross performance returns were reduced by transactional costs and net of fee returns were net of all fees. The bundled fee includes all advisory, trading, custody, and administrative fees charged to the portfolios. The annual composite dispersion presented for years 2000 – 2004 is an equal-weighted standard deviation calculated for the accounts in the composite the entire year. The annual composite dispersion for year 2009 going forward is an asset-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. 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 are disclosed to allow for comparison of the investor's performance to that of certain well-known and/or widely recognized indices. You cannot invest directly in an index.

### COMPOSITE PERFORMANCE

COMPOSITE ASSETS (USD)			ANNUAL PERFORMANCE RESULTS				
YEAR END	TOTAL FIRM ASSETS (THOUSANDS)	COMPOSITE ASSETS (THOUSANDS)	NUMBER OF ACCOUNTS	COMPOSITE GROSS	COMPOSITE NET	RUSSELL 2000 GROWTH	COMPOSITE DISPERSION
2010	550,061	441,991	16	24.17%	22.98%	29.09%	0.12%
2009	441,668	228,833	10	34.45%	33.18%	34.47%	0.34%
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 <sup>1</sup>	n.a.*	108	five or fewer	(0.46%)	(0.92%)	1.48%	n.a.

<sup>1</sup> 1995 represents a partial year beginning 10/1/1995 and ending 12/31/1995.

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.



**SPARTA**  
ASSET MANAGEMENT

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