



RIVER ROAD
ASSET MANAGEMENT

Small Cap & Small-Mid (SMID) Cap Value Equity

November 2007



Featuring River Road Portfolio Managers:

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■ How is 2007 shaping-up for small cap stocks?

Small cap stocks have struggled since the second quarter of this year. Year-to-date performance now lags most asset classes, with Small Cap Value being at the very bottom. Keep in mind that for more than a year we have been cautious regarding the fundamental backdrop for small cap stocks. What has been surprising to us is the magnitude of the performance differential between Small Cap Growth and Value. We generally view a value approach as providing a cushion of safety in down markets. That is not always the case, though, especially in the early stages of a downturn. For seven consecutive months, the Russell 2000 Growth has outperformed the Russell 2000 Value. This has pushed the year-to-date spread through October to nearly 16%. If based upon annual comparisons, that spread would represent the third widest on record.

■ Why do you think growth is outperforming value in the current environment?

During the early stage of a correction, investors often seek areas of the market where earnings momentum remains robust. Across both the small and large cap market segments, growth stocks are generally growing their earnings while value stocks are not. Unlike the last market downturn, growth stocks are also cheap in their historical comparison to value.

■ Are Mid-Cap Value stocks performing better than Small Cap Value?

Yes. Equity performance year-to-date steadily improves as you go up the size curve. Mid-cap stocks are also experiencing stronger revenue and earnings growth than small cap. A key catalyst for launching the firm's Small-Mid (SMID) Cap Value portfolio in January was our desire to capture these opportunities as value migrated from small to large, a trend we have seen developing in our All Cap Value portfolio over the past 24 months.

■ How have the River Road Small Cap and SMID Cap Value strategies performed this year?

Performance has been good, though not spectacular. As of October 31, the River Road Small Cap Value composite portfolio has returned 3.17% (2.50% Net) year-to-date, versus -1.64% for the Russell 2000 Value. The Small-Mid (SMID) Cap Value composite portfolio has returned 4.11% (3.58% Net) since inception (March 1, 2007), versus -1.60% for the Russell 2500 Value. If you look at performance in November, which has been an absolutely terrible month for the market, we are again beating the benchmark but not by as wide a margin as we would like.

■ Has the credit crisis affected performance?

Yes, but not directly. Both the Small and SMID Cap portfolios have been significantly underweight financials for more than two years. Unfortunately, fallout from the credit crisis has negatively impacted just about every area of the market, particularly industries that are consumer-related.

■ What impact has being overweight Consumer Discretionary had on the portfolios?

In hindsight, we were too overweight retail and restaurant stocks coming into the correction. Historically, our discretionary holdings have done well when that sector is out of favor. From a risk control perspective, we also felt that our more defensive investments in both the Energy and Staples sectors would counter-balance our consumer exposure. We were wrong. Sentiment in the Discretionary sector became so negative, that poor performance among those holdings trumped strong performance from those more defensive groups. We also discovered that as we followed value up the size curve, we increased the Portfolio's betas. This, of course, increased the Portfolio's downside market risk.



■ **Have you trimmed your discretionary holdings as a result?**

Yes, but largely as a result of our portfolio sell discipline. Frankly, we are not as overweight discretionary holdings as the Russell sector scheme makes us appear. The GICS sector classification system separates business services (Industrials) from Consumer Discretionary, but Russell does not. Internally, we don't widely use either system, preferring simply to group like business models for the purpose of analyzing diversification. To avoid confusion and provide uniform data, however, in Q4 2007 we are going to begin reporting using the GICS sector scheme instead of Russell.

■ **Are any other trends impacting the portfolios this year?**

Fortunately, our bottom-up stock selection process led us to being underweight Financials and overweight Consumer Staples. This had a significant positive impact on performance. Our grocery and convenience retailers have been particularly strong, including **Ruddick Corp. (RDK)**, which operates the 159-store Harris Teeter grocery store chain in the mid-Atlantic and southeastern U.S.; **Village Supermarket Inc. (VLGEA)**, which operates 23 ShopRite supermarkets in the northeastern U.S.; and **Casey's General Stores (CASY)**, which operates more than 1,600 gas/convenience stores in the Midwest. More recently, being underweight Technology has hurt performance, though not significantly.

■ **What have been your top and bottom performing stocks this year?**

In both the Small and SMID portfolios the top performing holding this year has been **Aptar Group (ATR)**. Fortunately, Aptar has also been positioned as our largest holding since January. Aptar manufactures specialty dispensing systems for use in the personal care, fragrance, and pharmaceutical industries. The company has a fantastic operating history, strong management team, and arguably the strongest balance sheet in the industry.

The worst performer this year has been **Travel Centers of America (TA)**. TA is a textbook example of what can go wrong when you put too much faith in a strong balance sheet. Travel Centers of America operates and franchises a nationwide network of 233 truck stops. TA was a spin-out of Hospitality Properties Trust, a stock we own in our All Cap Value (Dynamic Equity Income) portfolio. Spin-offs are usually an excellent source for "misunderstood" stocks. Despite \$24/share in cash, a great acquisition earlier this year, and a recent secondary offering at \$41/share, when TA posted disappointing results in the third quarter the stock got crushed. Though we had trimmed the position slightly just prior to the correction, there was no time to trim further. The conference call on November 13 to discuss those disappointing earnings was handled poorly by management and, consequently, the stock fell an additional 20%. In hindsight, our investment in TA was not a failure of our process or a breach of our discipline. Rather, because of the comfort we developed in the net cash balance and tangible book value, we moved too quickly to grow the size of the position before we had an opportunity to observe the actions of management.

■ **Has the current environment had an impact on your sell discipline?**

Yes and no. Clearly, when the market is in a protracted free fall we cannot continue to manage model portfolio losses at the same level we would in a normal market environment. Thus, today we are targeting a higher loss threshold in our model portfolios. That allows us to continue to actively trim losers without counter-productive trading and exceeding our mandated cash thresholds. Philosophically, however, nothing has changed. Unfortunately, unless you hedge or go to cash, even the best sell discipline cannot entirely stop a bear market.

■ **Where are you currently finding value?**

The good news is that some very attractive pockets of value have re-emerged in the small cap market. Consequently, the discount to value in our portfolios is significantly greater than the trough levels seen earlier this year. From an industry perspective, Specialty Finance is an area in which we have recently discovered several new investments. Many of these stocks appear to have been unjustly tainted with the sub-prime debacle, which has created some interesting opportunities. Unfortunately, the sector remains under pressure and, thus, our positions have been limited in size. Retail is probably the most attractively priced sector in the market and we believe significant gains may lie ahead in 2008 for that group. That sector, however, also remains in a sharp decline so new positions have been limited. Our Health Care investments have done very well this year and we continue to work on potential new investments across that sector.

■ Looking into 2008, what is your general outlook for small and mid cap stocks?

Our outlook is increasingly positive! Given relative valuation levels and that investors are becoming increasingly risk averse, however, we suspect larger cap stocks will continue to outperform in the near-term. To really re-ignite this market, we need the Fed to remain in an easing mode; we need oil prices to recede, even modestly; and, we need the housing and mortgage markets to stabilize. I think we could see all of these factors play-out in 2008. If that happens, M&A deals will also return, as companies and private equity firms are still flush with cash. When those deals do return, they will likely be more focused on small and mid-sized companies, rather than the mega deals we saw prior to the correction.

■ Do you anticipate any significant changes at the firm in 2008?

We are engaged in negotiations to purchase the 45% equity interest held in our firm by ABN AMRO Asset Management Holdings, Inc. If everything goes as planned, when that transaction is completed River Road will be owned 100% by the employees of the firm. That is a significant change and we believe a long-term positive for both our clients and our associates. Aside from that, 2008 will be a year in which we focus our collective efforts on integration and execution. We may add one or two staff members, including perhaps one new analyst, but you will not see the type of organizational growth we have experienced over the past two years.

Small Cap Value Equity Composite Portfolio and Small-Mid Cap Value Equity Composite Portfolio Disclosures:

River Road Asset Management, LLC (“RRAM” or “the Firm”) is a registered investment adviser formed in April 2005 and is 55% independently owned and 45% owned by ABN AMRO Holdings, Inc. RRAM claims compliance with the Global Investment Performance Standards (GIPS®). The firm maintains a complete list and description of composites and a presentation that complies with the requirements of the GIPS® standards, which is available upon request by contacting Thomas D. Mueller, CPA, CFA at (502) 371-4100 or thomas.mueller@riverroadam.com. Past performance is no guarantee of future results. Performance is shown gross and net of investment advisory fees. The U.S. Dollar is the currency used to express performance. Performance includes the reinvestment of all income. The Small Cap Value Equity Composite contains fully discretionary accounts that seek capital appreciation by investing in small cap equity securities that trade at a discount to the firm’s estimate of absolute value. The composite performance has been compared to the following benchmark: *Russell 2000 Value* – Unmanaged index constructed to provide a comprehensive and unbiased barometer of the small cap value market. The Small-Mid Cap Value Equity Composite contains fully discretionary accounts that seek capital appreciation by investing in small-mid cap equity securities that trade at a discount to the firm’s estimate of absolute value. The composite performance has been compared to the following benchmark: *Russell 2500* - Unmanaged index that contains the 2,500 smallest common stocks in the Russell 3000, which contains the 3,000 largest stocks in the U.S. based on total market capitalization. ABN AMRO Asset Management Holdings, Inc. (ABN AMRO) has a minority interest in RRAM. RRAM and ABN AMRO have entered into a solicitation agreement. ABN AMRO could potentially receive fees from River Road for client referrals. These referral fees will have no effect on investment advisory fees paid by a client.

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Upon formation, RRAM had several individuals, foundations, IRAs and common trust funds assigned to it from its prior firm. Prior to the formation of RRAM, the principals of the company were primarily responsible for the management of the accounts, from January 1, 1998 to March 31, 2005. The investment objectives, policies and strategies for the prior firm are substantially similar to those of RRAM. The prior firm has provided written authorization allowing RRAM use of the performance history and supporting records for this report.

River Road Small Cap Value Equity Composite						
10/31/2007						
	Oct 2007	YTD	1 Year	3 Year	5 Year	Inception*
Small Cap Value - Gross	1.74	3.17	10.02	21.51	25.45	15.70
Small Cap Value - Net	1.71	2.50	9.17	20.72	24.54	14.93
Russell 2000 Value	1.09	-1.64	2.05	12.34	18.60	10.18

* Inception Date: January 1, 1998

River Road Small-Mid Cap Value Equity Composite			
10/31/2007			
	Oct 2007	Inception*	
Small-Mid Cap Value - Gross	2.16	4.11	
Small-Mid Cap Value - Net	2.15	3.58	
Russell 2500 Value	0.69	-1.60	

* Composite Inception Date: March 1, 2007

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