COMMENTARY

March 25, 2011

Dear clients and colleagues,

Recently we attended two large conferences on US-listed small caps. One was the Raymond James Annual Institutional Investors Conference which had 1,700 attendees and 300 presenting companies. The other was the Roth Annual Growth Stock Conference which had 3,000 attendees and over 400 presenting companies (including 100 US-listed Chinese firms). We managed to meet with over 120 companies, including a dozen of the Global Small Cap Portfolio's existing holdings. Here are some takeaways.

Overall sentiment: companies and investors are very positive about the recovery.

We sensed a unanimous view across industries. All companies expressed confidence in the accelerating economic recovery and are back in growth mode. For US companies, capacity is not yet an issue, while many Chinese companies are already running at full capacity and speeding up expansion.

Key challenge: Margin expansion is getting difficult.

On one hand, many US companies managed to increase their margin back to the near-peak level, thanks to tight cost control and recovered top-line growth. Further margin expansion will be tougher in the near term. On the other hand, rising raw material prices add more pressure. For solutions, US companies believe they can offset rising costs with higher utilization rates, better sourcing, higher-margin product mix, and a gradual pass-through to customers. In reality, we think it might not be that easy because of reluctant consumer acceptance and/or fierce competition. In the case of some Chinese companies, we have already seen margin erosion.

Key opportunity: Emerging markets.

In terms of growth strategy, expansion to fast-growing regions was mentioned in almost every presentation. Commonly cited regions were China, India, Brazil, and the Middle East. Small US companies intend to use foreign local partners to gain access to these markets while larger companies aim to play big and act fast, therefore they prefer acquisitions of local firms.

Chinese companies: High interest from investors.

Among US brokers, Roth has the biggest coverage of US-listed Chinese companies. No surprise that the two presentation salons for Chinese companies were more crowded than average, often filled to capacity and sometimes with people standing at the back of salon. Compared to the 2008 Roth China Conference, this year we saw more industry-leading firms. Presentations were more investor-friendly and all were delivered in English (in 2008 many used interpreters). Communications were more effective in terms of content and presenting skills.

13 existing holdings: positive feedback.

Of the 120 companies we met, the 13 that we currently hold are clearly among our preferred names. They share the following common attributes: a big and growing target market, revenue growth faster than industry, clear growth strategy, strong competitive edge, high operating margin, and low/no debt.

Anecdotal evidence

These two annual conferences took place in Orlando, Florida and Dana Point, California respectively. As we do on all business trips, we tried to talk to locals, conduct retail checks and observe the local economies.

Orlando: busiest ever. Robert has gone to Orlando each year for the past decade, but this March was clearly the busiest he has ever seen. Big crowds flowed in shopping malls, restaurants, and tourist attraction areas. Staff at some hotels, retail stores and restaurants told us that business was picking up with increased tourism and large conferences taking place in Orlando. Many restaurants were fully booked for dinner, with an average wait time of 40 minutes. Imagine, it was even hard to find a parking space in the big outlet mall parking lot.

Dana Point: slower improvement and less confidence. Boasting one of the best beaches in California, this little area is a top choice for tourists and conferences. However, the scene seemed less rosy than in Orlando. Feedback showed that business is better than last year, but still far from the peak. Many complained about high gasoline prices and slow job creation. “We are worried that things will get worse again.” The shock of daily increasing gasoline prices was all over the local and national news on TV and in newspapers.

What do we think today?

We remain cautious in the short term. Economic recovery is facing mounting risks. Geopolitical unrest and the disaster in Japan are the new hits, but many old problems still remain unsolved although spoken of less often. Namely, the European debt crisis, high unemployment, a weak housing market, and food and oil price hikes. It is still a big question mark whether the highly indebted US consumer will be able to drive the economy forward once QE2 is withdrawn this June, especially in the context of expensive gasoline. Our portfolio is well positioned to benefit from the continued growth in the economy while we have a lower risk profile than the market.

Regards

The Global Alpha team