



## CAMBIAR MARKET COMMENTARY: LARGE CAP VALUE & SMALL CAP VALUE

CAMBIAR INVESTORS

### Overview

After four consecutive quarters of positive returns, equity markets reversed course in the second quarter. With negative returns being registered across the market capitalization spectrum, performance quickly became a relative issue. The wall of worry simply became too high for the market to climb in 2Q; while many of the domestic concerns are not new (continued high unemployment, the federal deficit, housing) the prospect of a sovereign crisis within the Eurozone and the potential for a hard landing in China galvanized investors to head for the exits.

With all due respect to the above-mentioned headwinds in the markets, the shift in investor sentiment from euphoria to panic over such a short timeframe is nothing short of amazing. Given the pattern of lower lows and lower highs, the biggest debate is whether the recent sell-off is a healthy correction of a market that has gotten ahead of itself, or the beginning of a double-dip recession. Cambiar is of the opinion that it is the former, but we are certainly on the lookout for signs of the latter.

While stock prices certainly imply a double-dip is in the offing, there should be confirming signals from other segments of the market as well. For example, the fixed income market is often a good early-warning signal for an ominous event in the equity markets; however, credit spreads remain relatively tame. And while commodity prices have retreated, they remain well above their 2008 lows, and meaningfully above their marginal cost of production. At the industry level, business conditions for most sectors we follow continue to improve. Metrics such as truck tonnage, railcar loadings, credit card delinquency rates and temporary staffing activity all point to an economy that continues to heal, not make a return to the intensive care unit.

A final non-trivial point as it relates to the potential for a double-dip recession – such a scenario has not occurred on its own since the Great Depression. The lone exception was in the 1981-82 timeframe, and this was an intentional move as part of the Fed's efforts to control inflation. Obviously one could take an 'it's different this time' stance; however, the fact that this is quite a rare event is worth considering when contemplating the future direction of the markets.

While it is impossible to exclude the macro from our investment thinking, the Cambiar investment team remains focused on closely watching our current holdings, while always seeking new opportunities. Given the recent sell-off, we are finding no shortage of attractive investment candidates.

### Cambiar Large Cap Value Portfolio Review

The Cambiar Large Cap Value (LCV) portfolio returned -12.2% (-12.3% net) in the second quarter of 2010, vs. a return of -11.1% for the Russell 1000 Value and -11.4 for the S&P 500 Index. While disappointed in our inability to do a better job protecting capital in the quarter, the time horizon we use for making buy/sell decisions is significantly longer than 90 days. Many of the portfolio's holdings are now trading at or near all-time trough valuations; this low multiple on low expectations scenario sets the stage for a material revaluation should these companies deliver on the earnings front and sentiment towards equities improves.

The second quarter provided a good illustration that you can analyze a company from every possible angle, but there is a serendipitous component to investing that cannot be predicted. The Deepwater Horizon Rig is one such example. The LCV portfolio owned British Petroleum and Anadarko, two

companies that are involved in the ongoing oil spill in the Gulf of Mexico. While Cambiar's quick response to liquidate both positions protected the portfolio from material capital losses, both of these names were negative contributors to performance. The oil spill, in tandem with fears of a global economic slowdown, put the entire energy complex on the defensive for the quarter. Looking ahead, one anticipated fallout from this crisis is that the subsequent marginal supply of oil production will be more expensive and difficult to produce, thus putting a floor under oil prices. While Cambiar's energy weighting is now lower vs. the past couple years, we continue to believe that there is a secular investment opportunity in the sector.

Cambiar's technology positions comprised another drag on performance in the quarter. While virtually nothing in technology worked during the quarter, an overweight allocation and lackluster stock performance did not help matters. Similar to other cyclical sectors, technology is correlated to the direction of the economy. Not surprisingly, these stocks lag when sentiment turns negative toward the outlook for the economic recovery. While we would agree that the trajectory of the recovery is slowing, the valuations of our tech companies imply zero or negative growth in many cases. We simply do not concur and are staying the course with many of our positions.

After lagging their peers during the market rally, the more-defensive utilities, telecom and consumer staples sectors proved their mettle by holding up better in the quarter. Cambiar's absence in utilities and telecom were subsequent performance detractors for the quarter. And despite a material overweight in consumer staples, Cambiar's holdings could not keep pace with the benchmark.

In a quarter that was short on bright spots, Cambiar did benefit from positive stock selection in the basic materials and industrial sectors. As business conditions continue to improve, our holdings in these sectors should be direct beneficiaries. And in a reversal from the first quarter, the LCV portfolio outperformed within the consumer discretionary and financials sectors.

## Cambiar Small Cap Value Portfolio Review

The Cambiar Small Cap Value (SCV) portfolio returned -7.4% (-7.6% net) for the second quarter, vs. a return of -10.6% for the Russell 2000 Value Index, and -9.9% for the Russell 2000 Index. While the market decline in the quarter brought year-to-date performance into the red for the small cap benchmarks, small cap companies have held up much better than their larger-cap counterparts. Cambiar is in select company with a positive year-to-date return at the halfway point of 2010.

One notable trend in the quarter was an uptick in merger and acquisition activity within the small cap asset class. Although Cambiar does not necessarily utilize a private market value investment approach, many of the criteria we look for in our companies – strong balance sheets, durable franchise, consistent free cashflow generation – happen to be the same characteristics used in m&a analysis. For the quarter, one Cambiar company was acquired, another holding made an accretive acquisition of a rival, and a third holding received a boost when it was disclosed that a notable activist investor had built a double-digit position in the company.

At the sector level, energy and consumer staples were two of the top contributors in the quarter. While the portfolio's overweight allocation was a small positive, it was stock selection that was the primary value-add vs. the benchmark.

Company performance within the technology sector was another relative value-add in the quarter. Cambiar has adopted an 'arms dealer' approach within small cap tech; rather than try to identify the next winner, we seek to own those companies who should benefit regardless of the vagaries of the mobile applications and devices markets. Examples include specialty materials, semiconductor testing and diversified semi companies.

While averaging less than 5% of the portfolio for the quarter, Cambiar's cash position was another positive contributor in the quarter. As many of our small cap holdings reached their respective price targets early in the quarter, the investment team sold/trimmed where appropriate. Now that the market has shifted to an oversold level, the investment team has begun to redeploy this cash balance back into the market.

Cambiar's underweight allocation to financials along with below-benchmark stock performance was the primary performance detractor in the quarter. One outlier to the downside was an asset management position; given the company's leverage to the equity markets, the stock declined in tandem with the commensurate selloff in equities. Cambiar initiated new positions in two regional banks that have strong capital positions and are poised to take market share in their respective markets.

The portfolio's contributions from the consumer discretionary, healthcare and industrial sectors are prime examples that it is hard to predict stock performance from one quarter to the next. Consumer discretionary was a positive contributor in the second quarter, after being a detractor in 1Q. Meanwhile, industrials and healthcare were both negative contributors to performance in the second quarter, while being positive contributors in 1Q. Despite the short-term underperformance, industrials and healthcare continue to comprise overweight allocations within the SCV portfolio, while exposure to consumer discretionary stocks remains low.

## Looking Ahead

After moving sharply higher over the past year, the markets have been in a state of decline since late April. The catalyst has been a topping in various leading economic indicators, as well as a ratcheting downwards of economic expectations. The market sell-off has caused treasury yields to plummet in the U.S., with similar appreciation in other risk haven asset classes. The divergent moves in stocks versus bonds has caused the equity risk premium (ERP) to rise from a seemingly normal level in the early spring back to a level consistent with historically high risk aversion and market stress. Cambiar calculates the current ERP to be at 4.7%; to put that in perspective, there are few breaches above the 3.5% level over the past 50 years.

Yet while the last notable rise in the ERP was due to the credit crisis, the financial markets today appear to be relatively stable. It is Cambiar's opinion that the bigger cause for the today's elevated ERP is an acute lack of investor confidence.

The paradox for value investors like Cambiar is that such sell-offs present very attractive entry points for longer-term investors. As such, we remain cautious on the market path from here, but are being opportunistic in those situations when the risk/reward profile is particularly compelling.

As always, we appreciate your continued confidence in Cambiar Investors.

The performance information depicted above represents the Cambiar Large Cap Value Composite (Institutional). Returns are net of transaction costs and include the reinvestment of all income. Gross returns do not reflect the deduction of management fees. Actual returns will be reduced by management fees. The client is referred to Cambiar's Part II of Form ADV for a full disclosure of the fee schedule. As fees are deducted quarterly, compounding increases the impact of the fees by an amount directly related to the gross account performance. For example, an investment of \$10,000 on 1/1/2009 would have resulted in \$14,029 on a gross of fees basis and \$13,970 on a net of fees basis at 12/31/2009 based upon the actual returns earned in the Cambiar Large Cap Value Composite (Institutional). The Russell 1000 Value Index is a market capitalization weighted index which contains securities from the Russell 1000 Index with a less than average growth orientation. The S&P 500 Index is shown to reflect general market conditions. The S&P 500 is a market capitalization-weighted index of 500 publicly traded stocks. Both the S&P 500 and the Russell 1000 Value Index are broadly based indices which reflect the overall market performance and comparisons may not reflect Cambiar's performance as compared to the performance of other investment advisors. These stock indexes assume reinvestment of dividends and capital gains, and assume no management, custody, transaction or other expenses. Cambiar's past results do not necessarily indicate Cambiar's future performance and, as is the case with all investment advisors who concentrate on equity investments, Cambiar's future performance may result in a loss.

The performance information depicted above represents Cambiar's Small Cap Value Composite. Returns are net of transaction costs and include the reinvestment of all income. Gross returns do not reflect the deduction of management fees. Actual returns will be reduced by management fees. The client is referred to Cambiar's Part II of Form ADV for a full disclosure of the fee schedule. As fees are deducted quarterly, compounding increases the impact of the fees by an amount directly related to the gross account performance. For example, an investment of \$10,000 on 01/01/2009 would have grown to \$14,718 on a gross-of-fees basis and \$14,574 on a net-of-fees basis on 12/31/2009 based upon the actual returns earned in the composite. The performance of the Russell 2000 Value benchmark and the Russell 2000 shown above include the reinvestment of all income and assume no management custody, transactions or other expenses. The Russell 2000 and Russell 2000 Value indices reflect overall market performance and comparisons may not reflect Cambiar's performance. The Russell 2000 Value Index measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. Cambiar's past results do not necessarily indicate Cambiar's future performance and, as is the case with all investment advisors who concentrate on equity investments, Cambiar's future performance may result in a loss.