Stephens
Investment Management Group®

The following contains a brief discussion from our Chief Investment Officer and Senior Portfolio Manager, Ryan E. Crane. Mr. Crane offers some insight on the equity markets and thoughts on our outlook for 2009.

MARKET OVERVIEW

Early in my career, I was sometimes admonished by those investment managers with far more experience that I hadn't known the pain and perils of a true bear market. It was true of course. (In a bull market, however, it might be beneficial to not be burdened with those scars.) Recently, my father, a sage and veteran investor, called to commiserate with me and said that now I too had lived through a bear market, the likes of which few had seen before.

I have mentioned in the past that when change comes, the effects tend to be more dramatic and its duration greater than anyone expects at the onset. And even with that in mind, it was nearly impossible to foresee the magnitude of this financial meltdown. What began as a sub-prime lending and housing problem has led to a banking crisis on top of a severe economic recession. The casualties of which have been household names like Bear Stearns, Lehman Bros., AIG and so on.

Credit is in some sense the oxygen of our economy. When it is plentiful, we breathe it in and it fuels us without much thought, but when it is absent, we instantly recognize the change and the cascade of deterioration in all other functions. The inability and the unwillingness of banks to lend have cut off some of the oxygen to our economy. And as consumers and businesses alike curtail spending, the entire economy has slowed.

Amid the volatility and fear, one of the surprising outcomes of this market environment was that nearly all segments of the market performed similarly. In industry jargon, "correlations went to one". Growth or value, technology or healthcare, large or small, performance was weak across the board. As a result, there was little dispersion among managers or indices.

As this financial crisis unfolds, it is clear that many investors had ventured too far in terms of risk. We have heard anecdotes of conservative investors buying collateralized debt obligations, thinking they were the same as investment grade bonds. The exponential growth of hedge funds has been met with massive withdrawals and closings. The knee-jerk reaction was to go to cash, and now cash positions are at record levels. Demand for safe harbors such as Treasury bills is evidenced by yields being bid to virtually zero. As investors rein in their exposure to unknown and riskier assets, and then start to redeploy their cash, we believe that they will focus on more traditional investments — domestic equities.

Additionally, when coming out of a recession, smaller growth companies have been the best performers historically. In the aftermath of the financial crisis and recession, opportunities should be created, and it is usually the high quality, efficient, nimble companies that seize them. As you know, these are just the sort of companies in which we seek to invest.

OUTLOOK

Throughout the year, we had been saying "things may get worse before they get better." *They got worse*. However, even as we are well into bear market territory and in the midst of a severe recession with no clear signs of improvement, all hope is not lost.

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Things could get worse still. The media and press can give you a full measure of that information. Rather than theorizing about what else could go wrong, I would prefer to focus on what could get better. There is good news. We believe that there are some prerequisites for a market improvement.

- Volatility must subside
- Valuations should be near or at a historical trough
- Growth expectations need to become overly conservative
- Capitulation

I think it is safe to say that the first two have been met. Without much mention in the press, volatility has quietly gone back to more normal levels. Valuations have come in a great deal, and were at historically low levels in November. The next two points are harder to make with any degree of certainty, but Wall Street has been aggressively cutting earnings estimates, in many cases doing so blindly, not based on specific fundamental knowledge, but simply for the sake of conservatism. We feel that, in and of itself, is a form of capitulation.

This does not necessarily mean that markets will instantly rebound. Growth expectations have more downside as do corporate earnings. It is likely that economic data, such as Gross Domestic Product (GDP) growth and unemployment may continue to weaken, but we believe equity markets should almost certainly rebound before we see improvement in economic data — the stock market is a leading indicator. So now, I can say with more certainty that it is possible that the worst is behind us, at least in the sense of stock performance.

Also, there are two other phenomena that give us reason to be optimistic. First, within nearly every sector, there were *some* winners — fewer and farther between, but winners nonetheless. This is the beauty of investing in smaller companies. Even in an abysmal market, there is almost always some little innovative company that can find a way to grow. Second, we feel the volatility and immense selling pressures combined with (at least some) capitulation have created potential opportunities in the market.

Whichever words you choose to characterize this market: bear market, market crash, severe recession, et alia, it is clearly a bad thing. But just as forest fires are a bad thing, there is good that comes from them. It used to be believed that forest fires should be prevented at all cost. But we have come to learn that forest fires serve a purpose, cleansing the forest of old and diseased trees, and enabling new ones to spring up and grow to greatness. A sad reality is that some trees must burn. So too must some companies. In times such as these, weak or over-levered companies, ones with bad business models, or bad management, are usually purged. Their stronger, healthier rivals are left to flourish in their absence, and opportunities arise for new business creation. We believe that we have bound ourselves to the sturdiest trees, and as the heat subsides, we are scouring the ground for fresh saplings.

Ryan Edward Crane

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Fund holdings and asset allocations are subject to change and are not recommendations to buy or sell and security. As of 12/31/08, the funds did not hold AIG, Lehman Brothers or Bear Stearns. **Current and future portfolio holdings are subject to risk.**

Correlation: Statistical measure of the degree to which the movements of two variables are related. The results range from 1.0 to +1.0.