

23 October 2007

# Active Voice: Small Cap

## Key Exhibits

High vs. Low Quality Sector Performance, pg 2

Industrials Foreign Exposure, pg 3

Industrials: Energy-related vs. Construction-sensitive Performance, pg 4

Small Cap Industrials Quality Metrics, pg 5

## Market Price Performance

As of 22 October	% Change	
	YTD	Since Jan '06
Cirrus MSX Industrials	30.7	55.8
Cirrus Mid Cap Industrials	37.6	63.0
Cirrus Small Cap Industrials	22.6	49.7
Cirrus Micro Cap Industrials	18.3	34.2
S&P 500 Industrials	11.3	25.6
S&P Mid Cap Industrials	22.6	36.9
S&P Small Cap Industrials	14.3	34.3
Ind. Select Sector SPDR Fund	14.4	27.5
iShares DJ US Ind. Sector Fund	14.3	27.9
Vanguard ETF Industrials	15.6	31.7
PowerShares Dyn. Ind. Port.	18.3	---
Rydex ETF S&P Eq. Wt. Ind.	14.6	---
iShares S&P Global Ind. Fund	17.8	---
Wisdom Tree Intl Ind. Fund	6.1	---

Valuation levels and high earnings expectations of industrial-based stocks force a selective posture. Three themes to isolate and leverage within the Industrial sector: High Quality, Foreign Exposure and Energy-related Spending.

## Trade Ideas

### ■ #1: Quality. Growth managers buy Quality, not Cyclical, right?

Adopt a quality bias among Industrials as the Industrial run gets into its later stages. A relative value basket that is long higher quality over lower quality industrial names allows one to maintain exposure and yet mitigate some of the valuation/cyclicality risk that can accompany this sector.

### ■ #2: Foreign Exposure & Industrials – It's all about China.

Long a basket of Industrials with high foreign revenue exposure. Such firms are likely to benefit from global industrial spending and a weakening dollar.

### ■ #3: Energy-related Industrials lead Construction-sensitive Industrials.

Long a basket of Industrials likely to benefit from increased industrial spending tied to rising energy costs. Short a basket of Construction-related Industrials to limit the downside from the on-going downturn of the housing sector.

## Active Voice: Small Cap

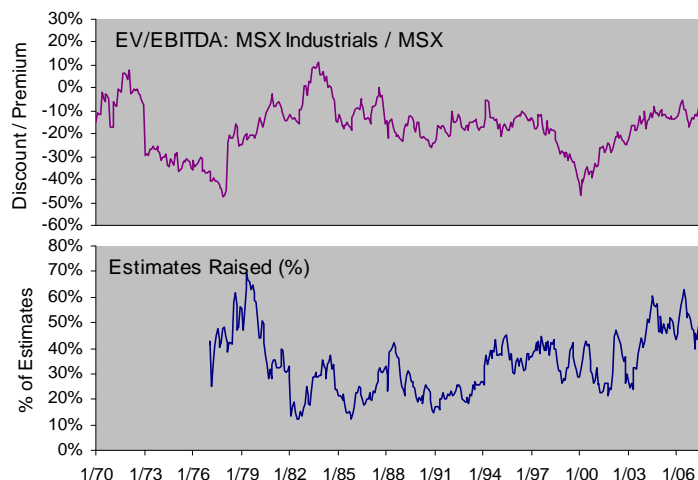
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Fig 1: High valuation levels and lofty earnings forecasts among Industrial stocks force selectivity.



Source: Cirrus Research, I/B/E/

**Small Cap Industrials:  
Quality Rankings**

		Mkt Value
<b>Aerospace &amp; Defense</b>		
Ceradyne Inc.	CRDN	1,973
BE Aerospace Inc.	BEAV	3,601
Moog Inc. (CI A)	MOG.A	1,809
<b>Building Products</b>		
Lennox International	LII	2,434
Goodman Global Inc.	GGL	1,612
Simpson Manufactng	SSD	1,599
<b>Const. &amp; Engineering</b>		
EMCOR Group Inc.	EME	2,019
URS Corp.	URS	2,835
Washington Grp Intl.	WNG	2,480
<b>Elec. Comp. &amp; Equip.</b>		
Acuity Brands Inc.	AYI	2,292
Woodward Governor	WGOV	2,011
General Cable Corp.	BGC	3,045
<b>Multi-Industry</b>		
Walter Industries Inc.	WLT	1,317
Sequa Corp. (CI A)	SQA.A	1,877
Tredegar Corp.	TG	692
<b>Const. Machinery</b>		
Astec Industries Inc.	ASTE	1,119
Cascade Corp.	CAE	891
Bucyrus Intl Inc. CI A	BUCY	2,337
<b>Farm Machinery</b>		
Toro Co.	TTC	2,353
Blount International	BLT	648
<b>Heavy Trucks</b>		
Wabtec	WAB	1,826
FreightCar America	RAIL	556
Force Protection Inc.	FRPT	1,175
<b>Industrial Machinery</b>		
Crane Co.	CR	2,671
Middleby Corp.	MIDD	1,220
Actuant Corp. (CI A)	ATU	1,672
<b>Industrial Dist.</b>		
Watsco Inc.	WSO	1,352
Applied Industrial Technologies	AIT	1,379
UAP Holding Corp.	UAPH	1,557

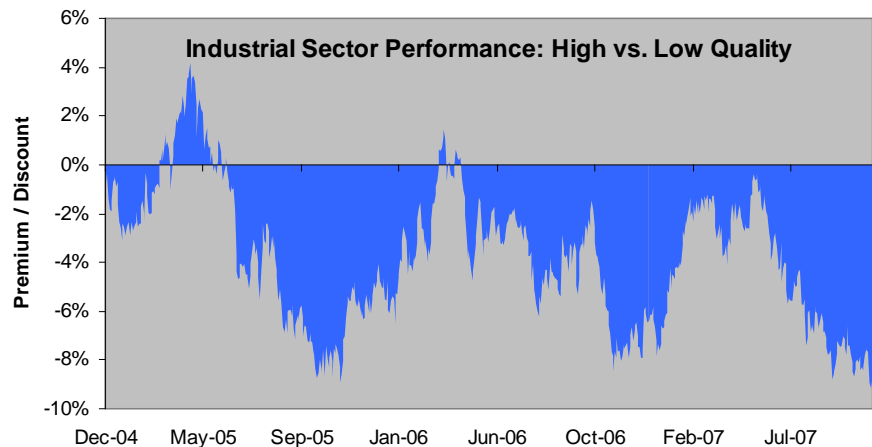
**Quality – Growth managers always buy Quality, not Cyclical, right?**

**Trade Idea: Adopt a quality bias among Industrials as the Industrial run gets into its later stages. A relative value basket that is long higher quality over lower quality industrial names allows one to maintain exposure and yet mitigate some of the valuation/cyclicality risk that can accompany this sector.**

As a penchant for conservative investments and visible earnings becomes more prevalent, a higher quality bias can only become a dominant trait among Industrials. While it appears that market participants continue to chase after cyclicality, we see the Industrial sector evolving from a pure cyclical to “growth cyclical.” The incremental buyer of this sector may be the “high quality growth” manager. Furthermore, a quality bias seems appropriate as growth and quality-growth managers pay greater attention to the Industrial sector. Additionally, continuing concern over consumer credit underscores a broad market-based quality bias.

Figure 2 relates a simple performance spread between higher quality and lower quality industrials. The term “quality” is captured here via a simple combination of Return on Equity, Leverage (Debt to Total Capital), Size (Market Capitalization) and Earnings Dispersion (standard deviation of estimates divided by mean consensus estimate for the current year). Higher quality industrials have underperformed lower quality by almost 10% in just a few months.

Fig 2: The rush to lower quality Industrials appears in vogue. High sector valuations could easily reverse the low-quality bias.



Source: Cirrus Research

## Foreign Exposure & Industrials – It's all about China.

**Trade Idea: Long a basket of Highly Foreign Exposed industrials to benefit from the global growth industrial spending trend and weak dollar and offset the domestic bias of small stocks.**

### Small Cap: Top Foreign Sales Exposures

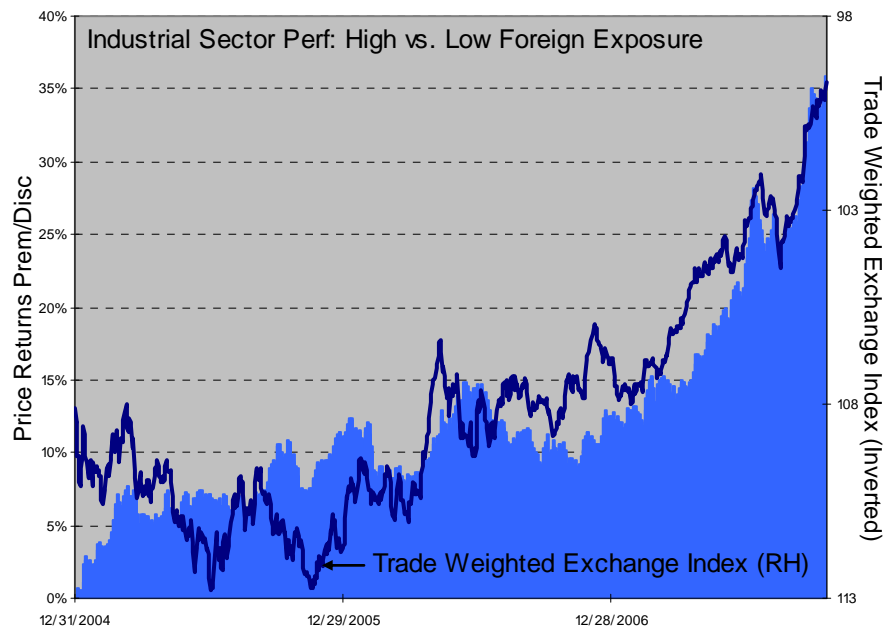
	Ticker	% Sales
<b>Aerospace &amp; Defense</b>		<b>22%</b>
DynCorp Intl Inc.	DCP	68%
Hexcel Corp.	HXL	49%
Moog Inc.	MOG.A	36%
<b>Building Products</b>		<b>12%</b>
Lennox Intl Inc.	LII	23%
Ameron Intl Corp.	AMN	21%
Griffon Corp.	GFF	21%
<b>Const. &amp; Engineering</b>		<b>8%</b>
Insituform Tech. Inc.	INSU	25%
Washington Group Intl	WNG	21%
URS Corp.	URS	9%
<b>Elec. Comp. &amp; Equip.</b>		<b>58%</b>
First Solar Inc.	FSLR	100%
GrafTech Intl Ltd.	GTI	69%
Power-One Inc.	PWER	64%
<b>Multi-Industry</b>		<b>28%</b>
Sequa Corp.	SQA.A	53%
Tredegar Corp.	TG	36%
<b>Const. Machinery</b>		<b>43%</b>
Bucyrus Intl Inc.	BUCY	49%
Cascade Corp. Inc.	CAE	45%
NACCO Industries Inc.	NC	39%
<b>Farm Machinery</b>		<b>32%</b>
Blount Intl Inc.	BLT	51%
Toro Co.	TTC	27%
<b>Heavy Trucks</b>		<b>18%</b>
Wabtec	WAB	34%
<b>Industrial Machinery</b>		<b>36%</b>
Nordson Corp.	NDSN	67%
Albany Intl Corp	AIN	65%
Robbins & Myers Inc.	RBN	59%
<b>Industrial Dist.</b>		<b>12%</b>
TAL Intl Group Inc.	TAL	90%
Williams Scotsman Intl	WLSC	13%
Applied Ind. Tech. Inc.	AIT	12%
<b>Small Cap Industrials</b>		<b>30%</b>

Source: Cirrus Research, Compustat

China. Need we say more? The industrial demand trend in Asia will continue to dwarf US industrial spending over the next few years. Consistent with this is a bias to look to firms that have strong overseas exposure. Clearly, the weakening greenback can only exacerbate current trends. The relative performance curve, Figure 3, indicates that stocks with high foreign revenue exposure in the Industrial sector are dominant. Unless one can position on a strong US dollar, this high foreign exposure basket remains a crucial way to isolate Industrial sector leadership.

The basket of Industrial firms with high foreign revenue exposure (40% or greater sales outside the US) outperformed the basket of their lower exposed counterparts by roughly 35% since January 2005. Benefits of foreign revenue sources do not appear to be limited to firms with direct business in the Far East, but also our neighboring trading partners, Mexico and Canada.

Fig 3: The Industrial build-up in Asia coupled with a plummeting US Dollar should continue to drive highly foreign exposed Industrial firms.



Source: Cirrus Research, Federal Reserve

## Focus on Industrials that benefit from rising energy costs, not on Housing/Construction

**Trade Idea:** Long a basket of Industrials likely to benefit from increased industrials spending tied to rising energy costs. Short a basket of Construction-related Industrials to limit the downside from the on-going downturn of the housing sector.

Decomposing the Industrial sector into select end markets presents a distinct divide. The market favors those companies selling into energy- and power-related industries and is understandably cautious about those selling into construction markets. The weakness in housing-related and construction-centric groups is tied to the markets' on-going concerns that consumer credit and the housing market can only slow further.

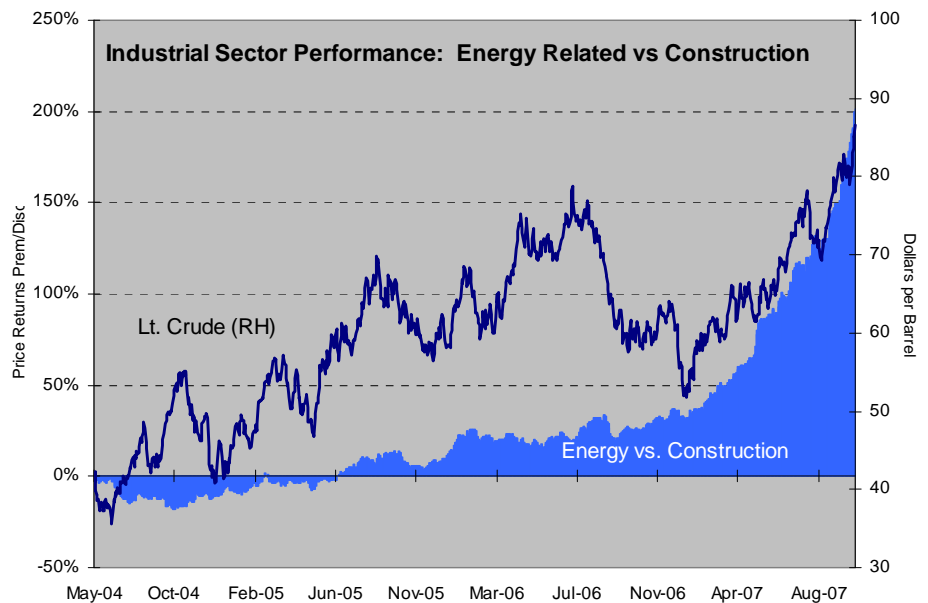
Figure 4 depicts the performance of the energy-tied Industrials. In short, the market has continued to favor this sub-segment of the Industrial exposure. Unless one has a radically more constructive view on the Housing/Consumer Credit situation, this current leaning towards Industrials, and more importantly, Industrials with an energy/efficiency bent, this trade remains open.

### Small Cap Industrials: Top Energy Exposures

	Ticker	Mkt Cap
<b>Elec. Comp. &amp; Equip.</b>		
First Solar Inc.	FSLR	7,573
<b>Const. Machinery</b>		
Bucyrus International Inc. (CI A)	BUCY	2,337

Our 16 October *Active Voice* report on Industrials argues that industries such as Construction & Engineering and Construction Machinery are expensive.

Fig 4: Markets are likely to reward energy-related Industrials and penalize those firms related to Housing and Construction.



Source: Cirrus Research

## Small Cap Industrials: Quality Metrics

		Valuation				Quality Metrics		
		Fwd P/E	EV/EBITDA	Price/Book	ROE	Debt/Cap	Market Value	Earnings Dispersion <sup>1</sup>
<b>Aerospace &amp; Defense</b>								
CRDN	Ceradyne Inc.	13.9	N/A	4.0	30.8	0.06	1,973	0.02
BEAV	BE Aerospace Inc.	26.2	16.2	3.1	11.1	0.04	3,601	0.03
MOG.A	Moog Inc. (CI A)	19.0	10.8	2.1	11.3	0.23	1,809	0.00
<b>Building Products</b>								
LII	Lennox International Inc.	13.7	N/A	2.7	16.7	0.07	2,434	0.01
GGL	Goodman Global Inc.	16.6	10.0	2.8	14.8	0.34	1,612	0.02
SSD	Simpson Manufacturing Co.	17.7	8.3	2.3	13.2	0.00	1,599	0.04
<b>Const. &amp; Engineering</b>								
EME	EMCOR Group Inc.	19.8	N/A	2.6	13.2	0.00	2,019	0.01
URS	URS Corp.	22.7	10.6	1.8	8.0	0.04	2,835	0.01
WNG	Washington Group Intl	30.2	16.4	2.9	6.9	0.00	2,480	0.01
<b>Elec. Comp. &amp; Equip.</b>								
AYI	Acuity Brands Inc.	15.1	N/A	3.4	22.6	0.14	2,292	0.01
WGOV	Woodward Governor Co.	25.4	N/A	3.7	14.4	0.03	2,011	0.00
BGC	General Cable Corp.	16.8	9.2	5.6	32.6	0.21	3,045	0.01
<b>Multi-Industry</b>								
WLT	Walter Industries Inc.	14.9	N/A	30.2	290.4	0.60	1,317	0.06
SQA.A	Sequa Corp. (CI A)	N/A	N/A	2.5	8.6	0.28	1,877	N/A
TG	Tredegar Corp.	17.7	N/A	1.3	7.6	0.04	692	N/A
<b>Const. Machinery</b>								
ASTE	Astec Industries Inc.	21.6	11.5	3.2	14.8	0.00	1,119	0.05
CAE	Cascade Corp.	15.4	9.7	2.9	20.1	0.05	891	0.01
BUCY	Bucyrus International Inc.	21.9	19.5	3.3	13.2	0.19	2,337	0.02
<b>Farm Machinery</b>								
TTC	Toro Co.	17.0	N/A	4.9	28.7	0.09	2,353	0.01
BLT	Blount International Inc.	16.0	9.1	0.0	N/A	0.36	648	0.03
<b>Heavy Trucks</b>								
WAB	Wabtec	17.2	N/A	3.4	18.3	0.08	1,826	0.01
RAIL	FreightCar America Inc.	10.3	2.2	2.6	48.8	0.00	556	0.03
FRPT	Force Protection Inc.	32.6	33.4	5.1	15.0	0.00	1,175	0.12
<b>Industrial Machinery</b>								
CR	Crane Co.	15.5	8.6	2.7	17.5	0.13	2,671	0.01
MIDD	Middleby Corp.	21.9	14.8	9.4	38.6	0.07	1,220	0.01
ATU	Actuant Corp. (CI A)	19.1	N/A	3.3	21.0	0.25	1,672	0.00
<b>Industrial Dist.</b>								
WSO	Watsco Inc.	17.6	10.3	2.5	15.0	0.02	1,352	0.01
AIT	Applied Industrial Technol.	14.8	8.9	3.1	18.8	0.05	1,379	0.02
UAPH	UAP Holding Corp.	17.5	9.4	5.5	35.8	0.27	1,557	0.03

<sup>1</sup> Earnings Dispersion is defined as the Standard deviation of earnings estimates divided by the consensus mean estimate for FY1.

Source: Cirrus Research

## Analyst Certification

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Asset Class	Market Cap Range
Nano Cap	\$10 mn - \$100 mn
Micro Cap	\$100 mn - \$600 mn
Small Cap	\$600 mn - \$2.4 bn
Mid Cap	\$2.4 bn - \$10 bn
Large Cap	>\$10 bn