# HAHN CAPITAL MANAGEMENT, LLC

## MID CAP VALUE
## EQUITY STRATEGY

**4th Quarter Commentary**

### THE ECONOMY AND EQUITY MARKETS

We are happy to say farewell to 2008. The year proved to be the most challenging in decades for the U.S. economy, the financial markets and the psyche of most Americans.

The fourth quarter capped off a year that witnessed persistent deterioration in the housing market, in our commercial banking system, and in the labor markets. It became clear with each data point reported that the economy was mired in a recession which was likely to be deeper and longer than forecasters had predicted earlier in the year.

By year end, average home prices nationwide had fallen over 20% from their peak in 2006, despite government intervention in the mortgage markets designed to stem the rising tide of foreclosures. Moreover, the unemployment rate reached 7.2%, bringing the total number of jobs lost in 2008 to just over 2.5 million- the most since 1945.

Most of these jobs were lost in just the last four months of the year. No sector of the economy was spared except healthcare, education and government employment, all of which experienced limited growth

Against this deteriorating economic backdrop, the U.S. stock market had its third worst performance on record. It was a broad-based decline, sparing few investors save those that had sold stocks short. All U.S. stock market indexes were down, and so too were the global equity markets as the economic downturn spread beyond our shores.

### HCM PERFORMANCE

Our goal during this extraordinarily difficult fourth quarter period in the market was to manage the rising risk of owning equities during this period—in effect, to preserve capital as best we could and to lose less than the broader market.

| Annualized Returns As of 12/31/08 | 4Q 2008 | 1 Year | 3 Years | 5 Years | 10 Years | Since Inception 01-01-88 |
|---|---|---|---|---|---|---|
| HCM Gross of Fees | -24.58% | -30.90% | -5.43% | 2.18% | 6.28% | 13.39% |
| HCM Net of Fees | -24.83% | -31.67% | -6.40% | 1.17% | 5.26% | 12.31% |
| Russell Mid Cap Value Index | -27.19% | -38.44% | -9.98% | 0.33% | 4.44% | 10.80% |
| Russell Mid Cap Index | -27.27% | -41.46% | -10.68% | -0.17% | 3.19% | 10.19% |

*Performance results are determined with monthly valuations geometrically linked for period returns. The U.S. Dollar is the currency used to express performance. It should not be assumed that past performance is indicative of future results. Results are based on fully discretionary accounts under management, including accounts no longer with the firm. Returns are presented both before (Gross) and after (Net) of all fees, which may include management fees, legal, audit, tax and withholding tax on foreign dividends, where applicable and include reinvestment of all income. Net of fee performance are calculated using the highest advertised management fee. Gross of fee performance calculations are on a time-weighted, asset-weighted return basis and are before management fees, after commissions and after custodian fees. Net of fee performance are on a time-weighted, asset-weighted return basis and are after management fees based on an Annual Model Fee of 1.00% (100 Basis Points), after commissions and after custodian fees. Hahn Capital Management's advisory fees are described in Part II of SEC Form ADV. The equity segment returns of multiple-asset portfolios are included in the value equity strategy composite. Hahn Capital Management's returns from January 1988 to December 1998 reflect the equity segment of multiple-asset portfolios plus an allocation of cash in the amount of 5%, consistent with maximum cash level guidelines established by our institutional clients. Non-discretionary portions of an otherwise discretionary portfolio have been excluded when constructing composites.*

*The Index information contained herein has been obtained from sources that we believe to be reliable, but its accuracy and completeness are not guaranteed. It has been prepared solely for informative purposes. It is made available on an "as is" basis and should not be viewed as solicitation for business. The information contained herein may not be reproduced, in whole or in part, in any form, other than for your own personal, noncommercial use.*

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To this end, we benefitted from staying under-weighted in the areas of the market that, in our view, presented the most risk—Financial stocks, Materials and Consumer Discretionary stocks.

As the Table above shows, we achieved positive relative returns for both the final quarter and full year. We outperformed our primary benchmark, the Russell Mid Cap Value Index, by 2.35% in the fourth quarter.

For the full year period, we lost 30.90%, but outperformed our benchmark by 7.54%. We also outperformed all Russell and S&P market index returns for CY 2008 except the Russell 2000 Value index.

Our outperformance for the full year was derived almost entirely by our stock selection, as opposed to sector selection. We achieved 700 basis points of positive contribution to our relative return in several sectors of the market, including our holdings in the consumer discretionary, consumer staples, and health care sectors. In addition, we held a slightly larger-than-usual cash position which also made a positive contribution to our relative return for the period.

## PORTFOLIO ACTIVITY

### New Positions

There were no new positions added to the portfolio during the fourth quarter. However, we made quite a large number of adjustments in the weightings of our individual holdings during the period, using the broad market decline to add to our most undervalued companies. In addition, we reduced some of our positions that reached our maximum position weights due to outperformance.

### Positions Increased

**Southern Union Co. (SUG)** – We increased our position in Southern Union as we noted an increasing gap between our estimate of intrinsic value and the value accorded to the stock in the public market. Southern Union owns a world class network of distribution, storage and processing assets in the natural gas industry, and will continue to generate increasing levels of free cash in future periods due to planned project expansions We, are expecting to see a higher level of profitability due to increasing scale and pricing power.

**Hexcel Corporation (HXL) –** We increased our position in Hexcel Corporation during the quarter. Despite some lingering impact from the Boeing strike, we expect generally strong demand for Hexcel's composite product over a longer-term time frame. In addition, the widening perception of a global economic slowdown has created fears that the large backlog for new commercial jet deliveries will be severely pared back. We continue to expect that Hexcel has numerous business opportunities in the wind energy, military and other end markets that will support continued growth at Hexcel in the event that current business conditions in the commercial aerospace market deteriorate further.

**General Cable (BGC)** – We increased our position in General Cable. We believe that the company will continue to benefit from secular growth in new electrical infrastructure development in emerging markets and the growing need to replenish existing infrastructure in the western hemisphere. General Cable has proven itself to be a very sophisticated acquirer of companies and assets that will produce additional shareholder value.

**SEI Investments, Inc. (SEIC)** – We added to our position in SEI Investments as the decline in equity markets in 2008 has negatively affected the market's perception of the firm's long-term earnings power. SEIC's product and service offerings are taking market share and expanding profitability while the stock market is concentrating on near-term stock and bond returns, creating an opportunity to buy at prices well below our estimate of intrinsic value.

**PartnerRe LTD (PRE) –** We added to our position in PartnerRe during the quarter as the reinsurance market has become dramatically more attractive over the past few months due to two main factors: first, the capital impairment of the primary insurance industry will cause these companies to reinsure more of their books due to capital constraints; second, accident year losses have been quite high over the past 12 months, and hedge funds have been exiting the business – thus there is much less price competition in the reinsurance market than in recent periods.

**Jacobs Engineering, Inc. (JEC) –** We added to our position in Jacobs Engineering during the quarter as we carefully analyzed Jacobs business prospects for the coming years and decided that JEC's $16 billion backlog of business and the quality of its customer relationships should allow it to prosper even during a global recession.

Jacobs remains one of the best managed companies in our portfolio, has a pristine balance sheet and a business model that allows it to take market share during economic downturns.

**Neustar, Inc. (NSR)** – We increased our position in Neustar during the quarter. Neustar's core database management business serving the tele-communications industry continues to execute flawlessly and appears to be relatively insulated from overall economic activity. Neustar is also investing in new growth initiatives that should gain traction and produce excellent returns when economic conditions start to improve.

**Charles River Labs, Inc. (CRL)** – We increased our position in Charles River Labs during the quarter as its long-term potential seems materially undervalued due to near-term demand issues arising through its core customers, large pharmaceutical companies. Longer-term, we believe these customers will have to return to outsourcing its drug testing to Charles River Labs because of its monopoly position in research models and lower cost pre-clinical testing services.

**Omnicare, Inc. (OCR)** – We increased our position in Omnicare as its core institutional pharmacy business continues to gain traction against its long-term goals. Omnicare is the dominant service provider in this industry and has multiple opportunities to grow its business and increase margins over time.

## Positions Reduced

**Valeant Pharmaceuticals, Inc. (VRX)** – We reduced our position in Valeant as out-performance caused the position size to exceed our 5% limit during the quarter. Valeant continues to execute solidly on its long-term growth plans and has many levers to pull in future quarters in order to create superior shareholder returns, including geographic expansion, continued consolidation of the dermatology drug market, licensing of successful drug compounds in the infectious disease market and the continued sale of non-core assets.

**Carter's Inc. (CRI)** – We reduced our position in Carter's in keeping with our risk management policies. We added to this position back in the 3rd quarter but have since reduced it because of out-performance over the second half of 2008. We remain very confident in Carter's ability to continue to leverage brand awareness and achieve additional operating efficiencies.

**HCC Insurance, Inc. (HCC)** – We reduced our position in HCC Insurance as out-performance caused the position size to exceed our 5% limit during the quarter. HCC's business model is specifically designed to reduce underwriting exposure during robust economic times and to invest heavily when other insurers (and the economy) are suffering. We expect that HCC will continue to execute consistently on this model and deliver above market returns.

## Positions Sold

**Principal Financial Group (PFG) –** We sold our position in Principal Financial during the quarter. Principal has one of the most enviable business niches in the insurance sector. It has a sterling reputation among its customers and unrivaled brand strength. However, we started to become uneasy over Principal's unnecessarily-aggressive management of its balance sheet. In an era where mark-to-market accounting rules increase the volatility of a company's equity account, we felt that Principal was too highly leveraged, and compounding this leverage, the management appeared in denial about the need to raise additional equity. Principal has, since we sold the position, applied for TARP (The Treasury Department's "Troubled Asset relief Program") funds.

## MARKET OUTLOOK / PORTFOLIO STRATEGY

As we write this letter, the Obama administration is preparing to take the reins in Washington, and is expected to quickly introduce a number of bold fiscal spending measures to address the current economic crisis.

The first priority of this administration is to create new jobs. President-elect Obama has announced a sweeping plan designed to provide three million jobs over the next two years, much of which is focused on rebuilding this nation's eroding infrastructure of roads, bridges and other modes of transportation.

This initiative, along with proposed tax cuts and other measures, is expected to cost U.S. taxpayers over $800 billion. To further stabilize the financial markets, we expect that the banks will continue to receive allocations of the TARP funds and other government support in order to make credit easier for businesses and consumers to access.

To be sure, the U.S. government's enhanced role in establishing new policies and regulations governing the private sector, and particularly the financial markets, likely will be met with great skepticism and even resistance.

But a sense of urgency prevails, and there are few options to the immediately-needed fiscal and monetary stimulus. However, it will be imperative that the new administration focus on making structural reforms aimed at the **root causes** of the current crisis. Without a longer-term vision and strategy, any benefits from this stimulus program likely will be ineffective and short-lived.

At this juncture, it is particularly difficult for anyone to predict the outlook for the U.S. equity market in 2009 with so much economic uncertainty facing investors. Due to the serious decline in stock prices in 2008, there remains a considerable amount of fear and trepidation among market participants, as well as an elevated aversion to risk, that may limit the near-term upside in the equity markets. However, we observe that many equity valuations already reflect this fear and skepticism, sentiment is still bearish and there is a significant amount of cash on the sidelines. In the past, this combination of market characteristics has been the precursor to a market rebound.

Though the broader market outlook is uncertain, we expect some areas to prosper more than others. In our view, essential services within the areas of Healthcare, Utility Service, Infrastructure, and Technology will present attractive investment opportunities – even within the context of a struggling domestic economy.

Looking ahead, we believe there will be fewer investment opportunities for some time to come in the financial sector, and banks in particular, until their balance sheets improve materially and become more transparent.

We also believe it will be difficult to find good investments in the consumer discretionary sector. Many companies in this segment of the market are directly impacted by rising unemployment, the housing crisis and highly-leveraged consumer balance sheets. We expect over-capacity in the retail sector to lead to further company bankruptcies ahead.

So how will we sort out the winners from the losers in this dramatically changed economic environment?

In our view, the winners will be those companies that have created a sustainable competitive advantage and now have the opportunity to consolidate market leadership through strategic mergers and acquisitions of competitors.

Other winners will be companies with management teams that are seasoned, focused and properly incentivized to create long-term shareholder value. Finally, we expect better performance from companies with strong balance sheets, particularly those that can fund their growth from internally generated cash flows, given the rising cost of capital. Broadly speaking, we believe that investors will pay a premium for quality businesses.

In summary, while we are sobered by the current economic challenges facing this nation and do not expect quick fixes or easy solutions, we are hopeful and optimistic that a new President and administration will lead this country back to prosperity.

As stewards of our clients' funds, our primary focus is on managing risk in this precarious market environment. But we must also be mindful of, and take advantage of, the opportunities being presented by this recent stock market decline to invest for the longer-term in high quality companies whose current business values are at substantial discounts to what we believe they are worth.

In his commentary on the newest edition of Graham & Dodd's Security Analysis (the bible of value investors), value investor Seth Klarman said, ***"I don't need the entire market to be bargain priced, just 20 or 25 unrelated securities."*** We couldn't agree more.

As always, we welcome any comments you may wish to share with us.

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