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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Consistent Investing in Small-Cap Value Equities

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DOUGLAS G. PUGH, CFA, is a Principal and Portfolio Manager of Peregrine Capital Management, Inc. He joined Peregrine in 1997 as Senior Vice President and Portfolio Manager of the Small Cap Value style. Mr. Pugh is an Officer of the company and a Member of Peregrine's Managing Principals Group. He was previously Portfolio Manager and Investment Officer at Advantus Capital Management, where he was responsible for the small-cap value style. His previous experience also includes employment with Kemper Corporation as a Financial Analyst. Mr. Pugh received an MBA from the Carlson School of Management at the University of Minnesota and a B.S/B.A. from Drake University. He is a Member of the CFA Society of Minnesota and the CFA Institute.

JASON R. BALLSRUD, CFA, is a Principal of Peregrine Capital Management, Inc., and Portfolio Manager of the firm's Small Cap Value style. Mr. Ballsrud joined Peregrine in 1997 after graduating from the Carlson School of Management at the University of Minnesota, where he earned his B.S. and MBA in finance. While attending school, he worked with American Express Asset Management's Equity Group. Mr. Ballsrud is a Member of the CFA Institute and a past board Member of the CFA Society of Minnesota.

STEFANIE M. ADAMS is a Principal of Peregrine Capital Management, Inc., and Director of Client Service & Marketing. She joined Peregrine in 2003 and is responsible for client service and marketing of Peregrine's specialty equity strategies, with a primary focus on clients, consultants and institutional investors in the Midwest and New England states. Before joining Peregrine, Ms. Adams served as Director of Marketing for NorthShore Advisors LLC. Previously, she was a Principal of RBC Dain Rauscher Wessels, responsible for advising management teams as to appropriate trading, asset management and hedging strategies. Before joining RBC Dain Rauscher Wessels, Ms. Adams served as Vice President for Insight Investment Management, now Voyageur Asset Management, Dain Rauscher's asset management arm. While at Insight, she was responsible for developing and managing several of the firm's institutional client relationships in the Midwest and Pacific Northwest regions. She began her career in the investment industry at Piper Capital Management, where she served as Manager of Consultant Relations. Ms. Adams holds a B.S. from Georgetown University.

SECTOR — GENERAL INVESTING

TWST: To start, please give us a brief history of Peregrine, as well as an overview of the firm today.

Mr. Pugh: Peregrine Capital Management was founded in 1984. We are a boutique equity firm and offer three complementary, but disparate styles — Small Cap Value, Small Cap Growth and Growth Equity. Each team drives their own investment philosophy and process independent of the other teams. Three independent, entrepreneurial investment units roll into the Peregrine organization.

The Small Cap Value style is managed by Tasso Coin, Jason Ballsrud and myself. We are fully dedicated to the management of the Small Cap Value product and have worked together for over 15 years.

Currently, as a firm, we manage $2.5 billion and $903 million in our Small Cap Value style.

TWST: How would you describe Peregrine's overall investment philosophy and strategy?

Ms. Adams: I wouldn't say that the firm has an overall investment strategy, as the styles within the firm are all so very different. As a firm, our philosophy is to unencumber the investment teams as much as possible to allow them to have a dedicated focus on their particular style. The firm does not employ a CIO that dictates a specific macro view. Rather, each of the teams makes their own day-to-day decisions based on their well-defined investment process.

Mr. Ballsrud: Importantly, the firm's structure puts our focus on providing strong investment returns and excellent client service to a limited institutional client base.

TWST: Because we're going to focus on the Small Cap Value strategy today, would you give us a snapshot of the firm's Small Cap Value fund?

Mr. Ballsrud: On a high level, we are a fundamentally rooted, disciplined, pure Small Cap Value style. If you look over the history of the style, we consistently have had a lower price-to-earnings, price-to-book and price-to-cash flow than our primary benchmark, the Russell 2000 Value Index. And more importantly, since the inception of the style in 1996, there has been a tremendous amount of continuity within the team, and there have been no changes to the investment process. The consistency of the process and the continuity of the team has been a key differentiator for our style versus others.

TWST: What are the main criteria you use in selecting investments for the fund?

Mr. Coin: I think what would be most helpful is to briefly review our portfolio-construction process. The way we approach small value is on a sector-by-sector basis. We divide up our universe into discrete economic sectors of stocks that we believe move in kind and are affected by the same macroeconomic forces. Within each of those sectors, we focus on finding the best deep value names.

There are four parts to our portfolio construction process. The first step in the process is valuation analysis. During this step, we are simply determining which stocks are inexpensive within a given sector. We are not saying at this point in time whether or not the stock is a value. We are just saying, based on historically rooted criteria, this particular subset of stocks within this particular sector appears to be very cheap. It is the second step of the process, fundamental research, where the team spends the bulk of its time discerning if one of these very inexpensive names is, in fact, a value.

In determining whether a stock is a value or not, one of our five "value buy" criteria must be present. It is the presence of these criteria that gives us confidence that the stock can return to a state of fair value. Once we determine a stock is a legitimate value stock, we add it to the portfolio.

Typically, our top 10 holdings are usually those names that are most actively hitting on those "value buy" criteria, where the bottom 10 weighted names tend to be those seed positions that we hope will grow into our top 10 holdings.

As a final and important step in the process, we employ risk controls that keep our style very disciplined and focused. You will never see our style drifting out of either small cap or value. Style purity is important, because the Russell 2000 Value Index has been the most difficult benchmark to beat over time.

Mr. Pugh: Our "value buy" criteria include a resolvable short-term problem, a problem that is short-term in nature and entirely resolvable; a catalyst for change that fundamentally alters the way a company operates, driving increased value to company shareholders; unrecognized assets coincident with a plan, which will bring those assets to a full market valuation; fundamentally strong companies that are well positioned within their industries, but trade at discounts to their respective peer group; and finally, we have a high incidence of takeover activity in the portfolio, averaging 7% of the portfolio per year at an average premium of 30%.

We believe an inexpensive stock with the presence of one or more of these "value buy" criteria will enhance the probability that the stock will outperform its peer group and generate alpha for the portfolio.

Mr. Ballsrud: The final step, and an important element of the process, is portfolio construction. We align our sector weights, plus or minus 4%, to those of the benchmark, the Russell 2000 Value, so that the majority of our alpha generation will come from stock selection, not sector rotation.

Highlights

Stefanie M. Adams, Jason R. Ballsrud, Tasso H. Coin Jr. and Douglas G. Pugh of Peregrine Capital Management, Inc., discuss the firm's sector-by-sector approach to small-cap value investing. They say their investment philosophy is to allow its investment teams to have a dedicated focus on their particular style. And the firm's structure focuses on providing strong investment returns and excellent client service to a limited institutional client base. In discussing small-cap investing, they define the "value buy" criteria in their stock-selection process, which includes identifying fundamentally strong companies with resolvable short-term problems and unrecognized assets. They also said the Peregrine aligns its sector weights, plus or minus 4%, to those of the Russell 2000 Value, so that the majority of alpha generation comes from stock selection not sector rotation. The group offers names they like and names they are cautious about. Lastly, they touch on the attractiveness of U.S. equities, which they believe the prospects over the next couple of years are going to be as strong as in any other asset class. Companies include: Employers Holdings (EIG); AmTrust Financial Services (AFSI); Arctic Cat (ACAT); MedAssets (MDAS); Hanesbrands (HBI) and Suzuki Motor Corporation (TYO:7269).

TWST: Are there any specific sectors or industries Peregrine is most bullish on today, and likewise any that the firm is particularly cautious about?

Mr. Pugh: We view the current market as midcycle. Typically, coming out of a recession, we will be invested in deeper cyclical and early rotation sectors, such as financials, retail, autos and transportation. At this phase of the market, we are not finding sectors that are dominating overall performance. It's a stock pickers' market, where you can add a lot of value in individual stocks across all sectors.

Recently, we've brought up our weight in banks, as we had been underweight banks for a long time. We are not extremely bullish on banks right now, but we do believe they shouldn't be underweighted. We are seeing a strengthening of balance sheets. Most of the credit issues within the regional banks have been recognized, there shouldn't be too many surprises and credit trends are improving. We also see increased capital redeployment that will be shareholder friendly, including dividend increases and share repurchases. Possibly, we could see some banks engage in M&A activity with their excess capital. And frankly, valuations across the universe are reasonable at this point in the cycle. We believe that some of the banks, the better ones at least, are in a position to gain market share and grow profitably. If we get an increase in interest rates, which we think is quite possible, the asset-sensitive banks that we own will benefit from a higher net interest margin spread as well.

Mr. Ballsrud: "The final step, and an important element of the process, is portfolio construction. We align our sector weights, plus or minus 4%, to those of the benchmark, the Russell 2000 Value, so that the majority of our alpha generation will come from stock selection, not sector rotation."

1-Year Daily Chart of Employers Holdings

Chart provided by www.BigCharts.com

Having said that, within the financial area, we do like property and casualty companies, specifically some of the workers' comp stocks with California exposure such as **Employers Holdings** (EIG) and **AmTrust Financial Services** (AFSI).

Mr. Coin: One of the areas that we are de-emphasizing right now is utilities. You will see that our portfolio has a very large relative underweight in this sector, with only 3.7% of our portfolio allocated to this sector. We believe that utilities are very expensive right now because a lot of folks have been dividend-yield hunting. The dividend-yield play has been very popular over the past year. Since utilities tend to have higher yields vis-a-vis the other sectors, utilities have generally been bid up. We are not seeing a lot of opportunity in the sector.

We have also de-emphasized other sectors that have more defensive characteristics. This is part of the reason why our performance has been so strong over the past few years. We gathered significant absolute return performance off the lows of the market in 2009, while also driving strong stock selection on a year-in and year-out basis, resulting in us dramatically outperforming the Russell 2000 Value over the past one, three, five and 10 years.

Mr. Pugh: We have also trimmed back our weight in energy stocks. The energy sector has been a big source of outperformance over the past couple of years from our focus on small-cap, oil-dominated names.

TWST: Generally speaking, how easy or challenging is it to find good small-cap investments in today's market?

Mr. Ballsrud: Certainly, there have been times historically, when there has been an abundance of opportunities, whether it was late 2008 or early 2009, or going back to 2000 when the tech bubble burst. We would say now it is still a good environment for stockpicking. You can find stocks looking across each and every sector with good opportunities and attractive valuations within them.

1-Year Daily Chart of Arctic Cat

Chart provided by www.BigCharts.com

For example, we purchased a company called **Arctic Cat** (ACAT) last year. They manufacture ATVs and snowmobiles. The name came out of our valuation-screening process. It was very inexpensive, trading at its book value with a price-to-earnings multiple of seven times and at 5.5 times cash flow.

We identified a number of catalysts for change within the company that we thought would drive upward price appreciation. A key catalyst was a new management team that was focused on cutting costs and improving profitability. The snowmobile market had been very weak for a number of years. We observed that inventories were very low at the retail level and there was a tremendous amount of pent-up demand. Since we purchased the stock, order volume has increased dramatically. On the ATV side, **Arctic Cat** did not have what is called a side-by-side offering, a larger ATV, which is the fastest-growing segment of the market. Late last year, they launched a new product called the Wildcat, which provided an entry into that market. The Wildcat has been well received and has driven significant order volume.

Another catalyst that we identified was the potential for **Arctic Cat** to buy out their engine partner, **Suzuki** (TYO:7269). They, in fact, announced the transaction shortly after we purchased the stock. Through the acquisition, they bought back a third of the company at $13 a share, and this is when the stock was trading above $20. They took their share count down from 18.5 million to 13.5 million, which was very accretive to earnings, an instant boost to earnings growth and absolute earnings power.

With that said, the stock has been under pressure because the company has spent a great deal of capital to acquire or build all the units in its software offering. As a result, the company has a fair amount of debt, which is viewed unfavorably in the current market environment. The company's balance sheet is about two-thirds leveraged on a debt-to-cap basis. We purchased the stock at $10 a share — and it is still trading at a very modest $13 a share — around nine times earnings.

I'll also point out that **MedAssets** has a very high amount of recurring revenue given its software subscription model, which yields predictable cash flows. They are at a point that they have done the hard work, laid the groundwork and built their systems out. Now, it's a question of penetration and increasing market share. We believe their customer base is going to be very receptive to their products because they are part of the solution as opposed to the problem in health care. We like **MedAssets** a lot right here. We think the stock can easily trade into the low $20s, and we view it as a very good deep value proposition right now.

Mr. Coin: "If you go back three years to the nadir of the selloff during the financial crisis, the average stock in our portfolio was trading at 62% of book value. Today, the portfolio is trading at 1.2 times book, which is interesting because it is still significantly below the 10-year average of the Russell 2000 Value, which is about 1.4 times book value."

Finally, through the downturn they did a good job of strengthening their balance sheet. They have a lot of cash on their balance sheet, which has allowed them to repurchase stock and has left them with a strong net cash position. Since we purchased the stock, it has done very well. Even though it was up 90% in the first quarter, it is still inexpensive.

Mr. Coin: I would like to add to your question about finding opportunities in today's market. If you go back three years to the nadir of the selloff during the financial crisis, the average stock in our portfolio was trading at 62% of book value. Today, the portfolio is trading at 1.2 times book, which is interesting because it is still significantly below the 10-year average of the Russell 2000 Value, which is about 1.4 times book value.

My point is, even though we have had some strong absolute and relative performance off the bottom, market valuations are still at or below the historical long-term averages as compared to the index. So it's neither hot nor cold. We're just finding an average valuation market, and with that, as Jason noted, we can find some really good names individually as we move around the various sectors and industries.

TWST: Would you mind giving us a few more examples, whether from among the fund's top holdings or among other favorite names and investment ideas today?

Mr. Coin: A name that is a recent purchase in the technology space is **MedAssets, Inc.** (MDAS). This is an interesting name because it's a software company that specializes in software systems that help improve and manage hospital efficiency. If you think about what is going on from a macro standpoint, both in terms of the health care debate and the aging of our population, reducing costs and delivering more care to a wider population base at less unit cost is a paramount objective. **MedAssets** developed a suite of software solutions that can be integrated into hospital operations to make them more efficient. We see this as a company that is very uniquely positioned to take advantage of this macro trend.

Mr. Pugh: Another name we like is **Hanesbrands Inc.** (HBI). They are a manufacturer of essential apparel, undergarments and some outergarments. Their brand names are Hanes, Champion, Playtex — brand names that we've all heard of. We really like this stock. It's trading at only 11 times 2012 earnings estimates, but we see a lot of catalysts in place for improved earnings and higher valuation.

1-Year Daily Chart of Hanesbrands

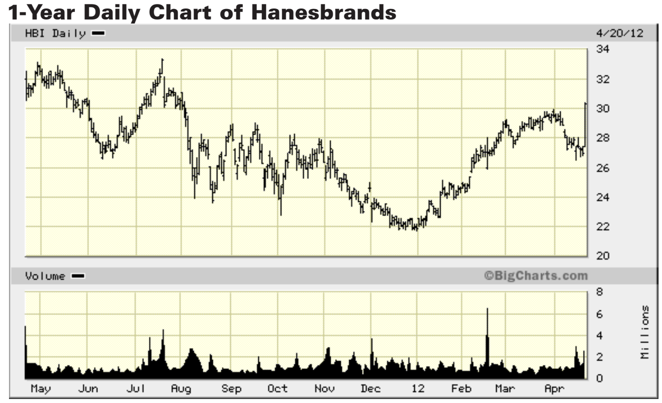

Chart provided by www.BigCharts.com

First of all, they reduced their exposure to the volatile screened-print shirt business. The unpredictability of earnings of this segment of their business made it difficult for the Street. Second, they have been hurt significantly by skyrocketing cotton prices. A pound of cotton went from $0.80 to $2 over the course of the last year and a half. Cotton has now come back to $0.84 a pound. As those costs roll through their contracts, they will have a pickup in their margins.

They have a lot of debt on their balance sheet, about 73% debt to cap, but they are a huge cash flow generator. Management expects to deploy that cash to pay down in the neighborhood of over $800 million in debt over the next year and a half. If they do that, they will save about $0.45 per share in interest costs. On top of that, we expect multiple expansion once the Street becomes comfortable with lower debt levels. Right now, **Hanesbrands** has a 14% free cash flow yield, which is very difficult to find elsewhere, so we are happy to have it in the portfolio.

TWST: You mentioned that Peregrine uses the Russell 2000 Value Index as a benchmark. Would you talk about the fund's performance and track record?

Mr. Coin: Our performance has been quite good. The reality is that small value took its disproportionate share of lumps during the credit crisis. We suffered during the fourth quarter of 2008 — the apex of the crisis. Our exposure to some of the regional banks led us to lag on a relative basis during that brief period. However, we took advantage of the panic and aggressively moved the portfolio into those names that we believed were what we call "first-round rotators." As a result, the outperformance of the style in the rebound year of 2009 was massive, easily outstripping the Russell 2000 Value by nearly 2,500 basis points that year. Since then, it continues to be a very good stock picker's market.

In addition, we have put up good relative numbers both in 2010 and 2011. If we look forward through the first quarter of this year, we have had a very strong start outperforming our benchmark on a relative basis by nearly 500 basis points as equity markets rallied. Generally speaking, our style does quite well in what we would categorize as either normal or recovery markets. We tend to lag a little bit going into a recession because of the economic sensitivity of the names that we hold. If you think about it, since most of the time we are in a normal or recovery market, it really favors our style over the long run.

Certainly, the unprecedented level of economic damage that was done during the credit crisis is something that none of us could have foreseen, and the level of relative underperformance was short lived. We were able to make up more than five times that in relative outperformance during the recovery period.

Mr. Ballsrud: I think over the long term if you look at the performance of the style, it does have a very high hit ratio. If you look at it in totality, the style has outperformed over the one-, three-, five-, seven- and 10-year periods, and since inception. We do have a healthy level of consistency, which is a big part of why we construct the portfolio the way we do — why we have a sector approach and manage the portfolio to always stay small cap and value.

TWST: What would you add in terms of the firm's approach to risk management? And what may lead to a decision to exit a holding?

Mr. Ballsrud: Our sell disciplines, just as our "value buy" criteria that we discussed earlier, are fundamentally based, as well. Our first sell discipline is what we call fair value. This is when we buy a stock, and the company executes as we expect. The stock moves from that lower 10% to 15% of valuation to a more fair valuation relative to its sector peers. The position is sold to maintain our style purity.

The next sell criterion is called better value opportunity. If we can find a stock that we see as having stronger "value buy" criteria, if we have greater conviction in the other company, or if we feel it's a higher-quality company, we will move an existing holding out of the portfolio to move in a better stock.

We will also sell a holding when a stock has experienced fundamental deterioration. As we monitor each stock relative to our investment thesis, our "value buy" criteria, if it doesn't play out as expected, if the fundamentals of the company deteriorate, we will sell the name out of the portfolio and replace to avoid any further loss.

And finally, we will profit take on positions, like **Arctic Cat**, when the stock does as we expect. We will lock in some gains from the stock and redeploy the proceeds into other names, the fresher names that are moving into the portfolio, prior to selling the position as a whole.

Mr. Pugh: And specifically, as it relates to risk management, we diversify the portfolio's holdings across 90 to 110 individual stocks. Second, our average weighting is 1%, and we do not allow any given position to be greater than 3.5%. We control our sector exposures by being weighted to the Russell 2000 Value plus or minus 4% to any given sector. We are not similarly constrained as it relates to industry weights, which can vary greatly to the benchmark.

Furthermore, we never own more than 5% of the outstanding float of a company, and we monitor liquidity on an ongoing basis to make sure that we can get in and out of any position on a timely basis. Our average position, we can get in or out of it in a single trading day's volume.

Mr. Ballsrud: Another risk control, and it's more of a stylistic control, if a company either merges or appreciates to the $3.5 billion level, we will sell that stock out of our portfolio by quarter end, as we believe it has reached the lower end of the midcap range. This is very important in the sense that it keeps us focused on style purity — $5 billion to $10 billion companies should not be in a small cap product.

TWST: For some closing comments, is there any advice you would offer investors today? And is there anything else you would like to add about the firm and what distinguishes Peregrine from peers or competitors?

Mr. Pugh: In terms of advice to investors, we've read about, seen and heard a lot about investors moving away from domestic equities over the last couple of years. Many are moving to global equities, bonds and alternative investments. While we're not criticizing those decisions, we do think that the message that has been lost is the attractiveness of U.S. equities right now. If you look back historically at other compression points, where the market has been flat for a decade or longer, coming out of those compression periods, small-cap stocks have generated outstanding absolute returns for an extended period — up to 20 years. We are currently seeing average stock valuations coincident with higher margins earlier in the cycle. As a result of the severe recession, we believe that most companies have substantially re-engineered and rede-

Mr. Pugh: "Right now, Hanesbrands has a 14% free cash flow yield, which is very difficult to find elsewhere, so we are happy to have it in the portfolio."

signed their business practices from raw material procurement to selling their product and everything in between. As a result, what we are seeing today are not peak gross margins. We expect to see higher margins throughout the course of this cycle — higher than we have seen in the past. So we remain strong believers in equities, and we think that the prospects over the next couple of years are going to be as strong in domestic equities as in any other asset class.

Mr. Coin: I would add from a firm marketing standpoint that the style is open. This style was closed in 2005. Obviously, with what's gone on and the turmoil of the markets, there has been some asset attrition along with some migration to other asset classes, like bonds. With slightly over $900 million in assets as of quarter end, our plan is to reclose the style once again at the $1.5 billion level.

Ms. Adams: I would further comment, the beauty of this style is its history, its continuity of the team, its consistency of its process and disciplines. You know what you are going to get. We consistently play within that small-cap value segment, and it has certainly benefited our clients over time.

TWST: Thank you. (MN)

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