

Out of Favor Small Caps

The Adirondack Small Cap Fund seeks to achieve its objective by investing in a diversified portfolio of undervalued equity securities (traded on U.S. exchanges) of companies with market capitalizations of less than \$3 billion. Fund managers Matt Reiner and Greg Roeder employ a contrarian selection strategy, which primarily focuses on out-of-favor securities. Market expectations for such companies are low, resulting in attractive valuations in certain cases.

What's your investment philosophy?

We are contrarian investors. The best opportunity for investment success is focusing on industries and stocks that have fallen out of favor with investors. We allocate capital to companies that in our view have the best chance of regaining investor support within three years. We look in all sectors for value. The best additions to the portfolio are ones that have little correlation with what we already own.

How does this philosophy translate into an investment process?

There are over 4,000 public companies in the United States with market capitalizations between \$100 million and \$3 billion dollars. That's too many stocks to monitor. One of our ways of reducing our research burden is by employing a "middle-down" approach. We start by looking for industries that offer attractive risk/reward and then we perform traditional bottom-up research. We keep tabs on capital flows within various industries and are very interested in capacity additions and deletions. We also track what key insiders are doing with their own money. We study industry structure in an attempt to avoid fundamentally flawed ones. We steer clear of over-hyped industries with extended

"The best opportunity for investment success is focusing on industries and stocks that have fallen out of favor with investors. We try to allocate capital into companies that have the best chance of regaining investor support over a three-year horizon."

winning streaks. This can eliminate a large bulk of stocks to analyze and it points us in the direction of overlooked industries.

We favor consolidating industries rather than ones where prosperity has attracted new participants. We are firm believers that as industries rationalize, pricing will get better and eventually stock prices will reflect that.

How low do you go in market cap?

We have gone as low as \$50 million at initial purchase. We will go into micro-cap territory when an extremely compelling risk/reward situation presents itself. However, those are typically non-core positions. Our sweet spot is typically in the \$500 million to \$1 billion market cap range. A core investment would be a 2% or 3% position. We do not let the position rise higher than 5%.

What are the advantages of contrarian investing?

In the small cap market, there is more inefficiency due to a lack of research coverage. Its one of the few asset classes where investors willing to invest the time can actually develop a formidable edge against the passively managed index. We like to find situations where there is a complete lack of interest in the company. We find that investor disinterest often reaches its highest point when a particular company or industry is about to finally turn its fortunes around. Timing is certainly critical as we don't want to catch a falling knife, but if we carefully wade into the water while maintaining a 3



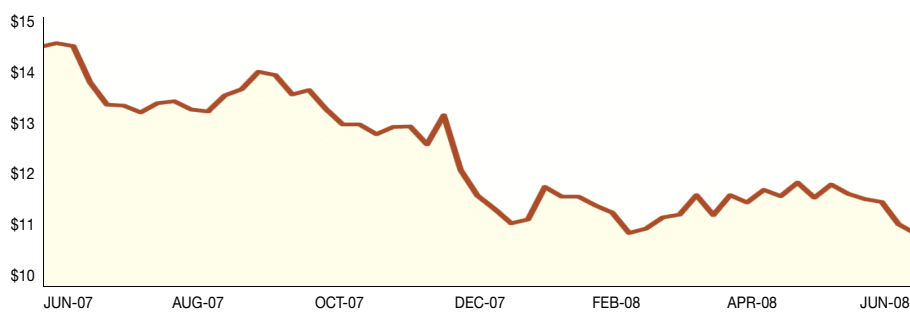
GREGORY A. ROEDER, CFA, founded ARMI in 2004. Roeder has 20 years of professional experience including twelve years with KeyCorp where he last served as Vice President. Roeder was an equity research analyst at CL King & Associates from 1997 through 2000. From 2000 through 2003, he was an assistant portfolio manager at Eddy & Wakefield. Roeder holds an MBA from Hofstra University.



MATTHEW P. REINER, CFA, joined ARMI in February 2005 as Principal and Portfolio Manager. Prior to joining ARMI, Reiner was a Vice President and Portfolio Manager at Paradigm Capital Management. Reiner worked in equity research for CL King & Associates from 1994 through 1997. He joined Paradigm Capital Management in 1998. He has an MBA from the University at Albany.

Performance - Price History N.A.V.

Adirondack Small Cap Fund (ADKSX)



	2005*	2006	2007
RUSSEL 2000 VALUE INDEX	8.77%	23.50%	-9.78%
ADKSX	16.60%	11.49%	0.09%

INCEPTION DATE APRIL 6, 2005

to 5 year time horizon, we can ultimately get paid handsomely for our patience.

For example, we own one particular stock, Dynegy, an electricity generation company that we have held since inception. At the time of purchase there were no analysts supporting the stock and the industry was despised. The common perception was that it would take a decade for the market to absorb the overcapacity stemming from the overbuilding of power generation during the previous five years. Dynegy is a company that avoided a disastrous merger with Enron. While the electrical generation industry was plagued with overcapacity, Dynegy also had a natural gas processing business that was operating well and could help them get by until it fixed its generation business. Yet the fundamentals of the industry were not as bad as everyone imagined. Demand was steadily growing in the low single digits and we knew that Dynegy had good assets near major load centers. Due to a dearth of new plant additions, the generation business started to fix itself. When it did, analysts started taking notice and the stock tripled.

What's your sell discipline?

When a company hits our target, we will take a portion of the position off the board usually around the 25% range and then reevaluate it. Dynegy is one of those names that we have taken profit off the board. After reevaluation we decided to hold onto the remaining piece because in our opinion there is still more upside.

An important element is the reevaluation process. We question whether the stock has kept pace with the fundamentals. In Dynegy's case, the long term fundamentals continue to improve. The regulatory hurdles for new plant construction at both the federal and local levels keep growing. The costs of new construction are skyrocketing and stricter environmental regulations could force a considerable amount of the nation's coal-fired capacity offline. These issues should ultimately increase the value of Dynegy's existing asset base.

What are the key elements of your research process? What is your buy discipline?

As mentioned previously our middle-down approach is a good starting point but it's not the source of every idea in the portfolio. We are constantly turning over stones. We attend conferences, run screens, confer with colleagues and utilize our past experience as analysts. The valuation metrics that we are normally interested in are price-to-cash flow, price-to-tangible book and enterprise value-to-revenues. Rather than picking some arbitrary discount to the market, we focus on finding opportunities where we believe risk/reward is asymmetrical.

When adding a name to the portfolio we try to answer the following questions: What's our downside? What is the earnings power of this company? Does adding this company help diversify the portfolio?

We run screens periodically to insure we are not missing anything. Recently, many airlines came up as attractive valuations. Before we did any work on the individual companies, we studied the industry and decided to pass as we felt that the entry barriers were still too low.

If the cursory analysis draws our interest, we dig deeper by analyzing the SEC filings in order to assess earnings quality. We will look at the trends, the competitive environment and the management record of accomplishment in capital allocation.

Can you give an example of a disappointment you encountered and how it was handled?

Avid Technology Inc. (AVID) is a stock that we liked when we started the fund that did not workout. The company provides software based technology to the media industry. After a decade of consolidation they emerged as the leader in this industry.

We saw a strong balance sheet and what appeared to be abundant opportunities for revenue growth. The management team appeared capable and there seemed to be further potential for margin expansion. The stock was in the high \$30's when we got involved. It quickly rose to the mid-\$50's, just shy of our price target. We became concerned when AVID's inventories started to grow faster than revenue. We ended up exiting with a small loss. The company's stock now trades in the teens and they have since replaced the management team.

Key Portfolio Features

- Concentrated portfolio with less than 60 holdings
- Approximately half of the portfolio is trading below book value
- Currently overweight Health Care and Technology

We are true believers in paying more attention to the numbers than management's story. The balance sheet signaled that they were having issues, but had we only listened to the story from management, we might have easily missed the red flags.

How do you go about portfolio construction? What benchmarks do you think people should compare you against?

Our maximum position size is 5%, our maximum sector exposure is about 30%, and we cap industry exposure at 10%. We tend to concentrate in our top 10 positions, which typically represent about 25-30% of our portfolio.

We compare ourselves to the Russell 2000 Value Index, although our sector weightings differ. The Russell 2000 Value Index holds a significant amount of financials and industrials. We have historically been underweight these sectors, not because we dislike them, moreover it's a function of our middle-down process, pointing us to areas with more attractive risk/reward. Like typical value investors, we look at downside risk before considering upside. We are very patient and we gravitate towards companies that have fallen out of favor. You will find many stocks in our portfolio that are trading at multiyear lows. Those are positions we will probably own for the next three to four years provided they execute.

What is the portfolio turnover?

In this volatile market, we have traded more than normal. We were originally under 25% annual turnover but during the past couple years we have averaged 82%. Part (15%) of the higher turnover in those years resulted from our holdings being acquired by either larger companies or private equity. The inefficiencies of the small cap market will sometimes compel us to trade around positions. If something is beaten up for no apparent reason we will take advantage of that and add to a position. For the same reason, if a stock outpaces its fundamentals we will not hesitate to sell it. We have a three year time horizon for our holdings. Yet, sometimes our ideas don't work out or


in some instances they reach our targets sooner. Therefore, on a long-term basis, we would expect the fund to experience turnover in the 50-70% range.

Since 2005 when you started the fund, how many of those original positions in names are still in the fund?

Currently we hold 49 positions, 16 (33%) of which have been in the portfolio from year one. We set price targets on positions prior to purchase based on the thesis that we set out. When it reaches it, we take a portion off and reevaluate. If it reaches more than 5% of the portfolio, we reduce automatically. If the investment thesis changes or does not play out the way we expect, we move on.

What risks do you monitor and how do you mitigate them?

Our retirement assets are invested alongside our fellow shareholders so the term "risk management" has a very personal meaning to us. Perhaps the biggest risk we monitor is capital market risk. We are attracted to companies that are self-funding while generally avoiding companies that may need to raise more capital in the near term.

Another way we mitigate risk is by building a portfolio in which the individual stocks have little in common with each other. We reject many fundamentally sound ideas because they correlate with something we own. This practice forces us to be more open minded when it comes to the industries in which we invest. Company specific risks are always present but we manage them accordingly. The stocks we buy are out-of-favor; therefore a quarterly earnings disappointment is not likely to ruin our day. The adage, "you can't fall out of a basement" is appropriate. The biggest danger we face is the company going out of business. We mitigate this by analyzing companies like bankers; focusing on balance sheet strength, cash flow and asset turnover. We also look for ways these companies can improve their situations through asset sales. Our risk management process seems to be working, as the funds volatility has been historically low relative to the index. 

Adirondack Small Cap Fund

Symbol **ADKSX**
 Website www.adirondackfunds.com
 Address Adirondack Research and Management Inc
 26 Valley Road
 Albany, NY 12205
 Telephone 888-686-2729
 Inception 04/06/2005

PORTFOLIO	
Total Net Assets*	\$9.5
Avg Mkt Cap (\$ Weighted) *	\$1,100
Average Price/Earnings Ratio	20.47x
Average Price/Book Ratio	2.67x
Turnover Ratio	77%

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	\$3,000
Min Subsequent Investment	\$50
Min Initial IRA Investment	\$1,000

RISK (AGAINST S&P 500 DAILY REINV IX - 3 YEARS)	
Alpha	0.07
Beta	0.85
R-Squared	0.61
Ann. Std Deviation	9.47
Sharpe Ratio	0.38

RETURNS VS. S&P 500 DAILY REINV INDEX		
	ADKSX	Index
1 Year (Cum.)	-12.58%	-6.70%
3 Year (Ann.)	7.34%	7.57%
5 Year (Ann.)	N/A	9.77%

RETURNS VS. RUSSELL 2000 VALUE INDEX		
	ADKSX	Index
1 Year (Cum.)	-12.58%	-15.33%
3 Year (Ann.)	7.34%	6.38%
5 Year (Ann.)	N/A	12.64%

FEES AND EXPENSES	
Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee**	1.00%
Total Expense Ratio	1.70%

PORTFOLIO MANAGER	
Matthew Reiner	2005
Gregory Roeder	2006

* millions ** within 1 month of purchase
 Data through: 05/31/2008; Source: Company Documents; Lipper

About Ticker Q&A

Our research staff analyzes and selects funds based on their consistency in performance and durability of investment style.

Each Q&A article covers investment philosophy and strategy, research process, portfolio construction and risk control for funds. These interviews uncover strategies and techniques that help to generate long-term investment goals.

You can find more fund profiles and view our other publications on Ticker.com and 123jump.com

Disclosure Statement

The Fund's prospectus contains important information about the funds investment objectives, potential risks, management fees, charges and expenses. For a prospectus containing details on risks, fees and expenses, please call 1-518-690-0470. Read it carefully before you invest.

This publication contains data on the past performance of the Adirondack Small Cap Fund. Past performance does not guarantee future results. Investment returns and principal value will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Returns do not reflect the deduction of taxes that a shareholder will pay on distributions or redemptions. Please consider the investment objectives, risks, charges and expenses of The Adirondack Small Cap Fund before investing. Current performance may be lower or higher than the performance data quoted.



www.AdirondackFunds.com

26 Vly Road
Albany, NY 12205
1-518-690-0470