Kayne Anderson Rudnick
Investment Management

Small Cap Quality Value Portfolio
Manager Commentary

2nd Quarter 2008

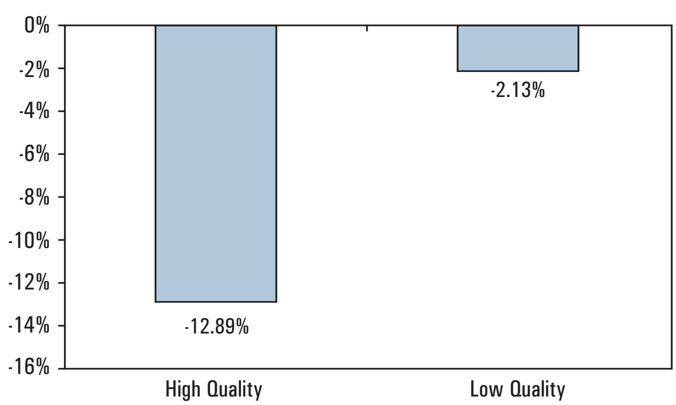
Market Overview

After rallying during April and May to erase much of the markets' first-quarter declines, the markets experienced one of the worst (if not the worst for certain indexes) monthly returns in history for the month of June. The markets continue to be affected by the slowing economy, persisting credit problems, and rising inflation. For the quarter, the Russell Midcap Index rose 2.67%, outperforming both the Russell 2000 Index (+0.58%) and the S&P 500 Index (-2.73%). Growth significantly outperformed value during the quarter, with the Russell 2000 Growth Index up 4.47% versus the Russell 2000 Value Index down 3.55%. Year to date through the second quarter, all equity indexes, regardless of asset class, were down in the high single-digit to low double-digit range.

Reflecting record high oil prices, energy was the strongest performing sector by a wide margin, increasing more than 30% in every small and mid-cap Russell index. Financial services was among the worst performers, continuing the trend experienced for several quarters, along with transportation and consumer staples, which were both impacted by higher commodity prices.

Low-quality stocks, as measured by S&P Quality Rankings, held up substantially better than high-quality stocks during the quarter (See chart: *Performance by S&P Quality Rankings*). Although high-quality should intuitively outperform in this type of market environment, high quality underperformed due to the large weighting of banks in the high-quality segment of the benchmarks, which were down considerably during the quarter. Excluding financials, the performance between high and low quality appeared more balanced. However, in the sectors where low quality outperformed, it was by a greater magnitude than in the sectors where high quality outperformed.

Performance by S&P Quality Rankings
Russell 2000® Value Index



Data is obtained from FactSet Research Systems and is assumed to be reliable.
Past performance is no guarantee of future results. Data is for the second quarter 2008.
High Quality - Stocks in the Russell 2000® Value Index with an S&P quality ranking of A- or higher.
Low Quality - Stocks in the Russell 2000® Value Index with an S&P quality ranking of B or less.

> "At this point in the cycle, we believe owning a diversified portfolio of companies with a high return on equity, strong balance sheets, and above market earnings growth is a prudent strategy."

– Robert Schwarzkopf, CFA
Chief Investment Officer & Portfolio Manager

– Sandi Gleason, CFA
Portfolio Manager

– Julie Kutasov, CPA
Portfolio Manager

Portfolio Overview

Despite the low-quality headwind, the Small Cap Quality Value Portfolio outperformed the Russell 2000 Value Index for the quarter due to strong stock selection.

The companies that contributed the most to performance during the quarter included Syntel and Lincoln Electric Holdings. Syntel, a leading provider of outsourced IT services, benefited from added capacity in India and strong demand for its high-margin business processing outsourcing (BPO) services. The company performed well despite economic worries, as more than 65% of its revenues come from "keep the lights on" types services, such as maintenance. Lincoln Electric Holdings is the world leader in arc welding equipment and consumables. The company continues to prosper from the strong industrial economies worldwide and the global infrastructure capital spending. Despite the commodity-cost headwind, the company has aptly improved on operating margins due to its ability to push through price increases along with good operational cost control.

Companies contributing the least to performance during the quarter included Cathay General Bancorp and Cherokee. Cathay General is the holding company for Cathay Bank, the leading California bank serving the ethnic Chinese community. With the Southern California housing market in turmoil, the stock suffered, along with those of other commercial lenders, with an exposure to the state's troubled residential construction segment. Although many expect credit costs to continue to rise after a number of years of above-average asset quality, charge-offs should remain manageable. In addition, because most of the lender's funding is variable and with deposit costs bottoming out, we expect net interest margin to increase in 2008. Importantly, with its core California footprint seeing a distinctive slowdown, the company is well positioned to benefit from its recent geographic diversification efforts. Cherokee, a marketer and licensor of several retail apparel brands, saw its shares slump in the quarter after outperforming during the first quarter of the year. Despite announcing in early 2008 a renewed a licensing agreement of its Cherokee brand to Target stores through 2012, results showed that the brand's sales at Target have declined over the past year. Although international retailer Tesco is becoming a larger piece of Cherokee's business, Target's decline hurt overall growth because the retailer has diversified its merchandise offering and seen overall weakness in its own

Continued on Page 2

sales. Still, with its low capital requirements and lack of inventory risk, we continue to admire Cherokee's business model in a volatile retail environment.

Purchases and Sales

In the Small Cap Quality Value Portfolio, we increased our positions in Chattem, Entertainment Properties Trust (EPT), and WD-40 Company, and sold our positions in Corus Bankshares and Jackson Hewitt Tax Service (Jackson Hewitt).

Chattem manufactures and markets a portfolio of over-the-counter health-care products, toiletries, and dietary supplements. The stock declined year to date (as of the date of the purchase program), driven primarily by investor concerns over ACNielsen's reports indicating negative revenue growth trends for the company as well as the recall of the Icy Hot Heat Therapy product in February. However, Chattem is seeing faster growth in more defensive Wal-Mart and club store channels that are not tracked by ACNielsen. Further, there are no indications that the Icy Hot Heat Therapy recall is affecting other products within the Icy Hot brand, with the brand showing increases in the first quarter and continuing to perform well in the second quarter. Chattem shows strong financials with profitability supported by the company's exposure to price-inelastic, over-the-counter, health-care categories coupled with its relatively limited exposure to rising commodity costs. With the stock trading at an attractive valuation, we added to our position in this solid consumer products company.

Created in 1997 as a spin-off from AMC Entertainment, EPT is the only publicly traded real estate investment trust (REIT) that focuses on the attractive niche market of high-quality single tenant megaplex movie theaters and entertainment themed retail centers located in the U.S. and Canada. EPT reported strong Q1 2008 results and increased its quarterly dividend 10.5%. EPT's balance sheet remains strong, with the company's recent capital markets activity serving as proof of the REIT's financial flexibility. With the stock down from its highs in February 2007 and trading at an attractive valuation, we increased our position.

WD-40 Company produces and markets lubricants, hand cleaners, and household cleaners worldwide. The stock declined following the company's 2Q08 reports of lower-than-expected top-line growth, primarily attributable to softening in promotional activity and retailer inventory reductions ahead of the launch of the WD-40 Smart Straw product, and overall weakening of the U.S. economy, which was offset by strong growth internationally. Importantly, the Smart Straw product will allow for a roughly 30% unit price increase and longer term profitability enhancement. With its highly efficient, primarily outsourced manufacturing model, WD-40 generates substantial free cash flow that it has used to buy back stock and execute occasional strategic acquisitions. With the stock down and trading at an attractive valuation, we increased our position in the company.

Corus Bankshares, Inc., is a bank holding company for Corus Bank, N.A., a commercial real estate lender focused on condominium construction and conversion projects located throughout the United States. In the quarter ended March 31, 2008, Corus saw earnings-per-share decline and the company continued to suffer from an industry-wide problem of heightened deposit costs. The combination of pressured interest income due to non-performing loans, alongside heightened deposit costs, led us to expect a protracted recovery process. We sold our position in the quarter.

Jackson Hewitt is a leading provider of tax-preparation services to the general public in the United States. On January 3, 2008, the IRS issued an advance notice of proposed rulemaking relating to Refund Anticipation Loans (RALs). The notice indicated that the IRS is considering restricting tax preparers' ability to market RALs to clients. Jackson Hewitt gets approximately 25% to 30% of its revenues and a higher percentage of profits from such financial products. Further, the company reported earnings that were well below consensus in Q1 with lower returns prepared, partially due to a lack of pre-season loan product that had been a key customer retention tool for the company. At the same time, industry office expansions have lowered the total returns per office. Theses statistics indicate that despite aggressive expansion efforts, the three large industry competitors are not gaining share from independents, but rather are cannibalizing from existing stores. The whole tax-preparation industry is facing competition from the Free File Alliance, a group of private companies that offers free federal tax filing to tax payers below a certain income threshold as well as the increasing use of software vendors, such as Turbo Tax and Tax Cut. With limited upside potential, a majority of our original reasons for purchasing the stock deteriorated in validity, and the franchise value of Jackson Hewitt diminished, we sold our position.

Outlook

Inflationary concerns, driven by the cost of oil rising to over $140 per barrel, are limiting the Federal Reserve's ability to further lower interest rates to stimulate the economy. Globally, higher inflation is leading policy makers to implement policies to slow growth. This should lead to a decrease in demand for commodities over time and, if past cycles repeat, lower prices. At this point in the cycle, we believe owning a diversified portfolio of companies with a high return on equity, strong balance sheets, and above market earnings growth is a prudent strategy.

Portfolio Characteristics

Quality	KAR Small Cap Quality Value	Russell 2000® Value Index
Return on Equity—Past 5 Years	23.8%	10.6%
Interest Expense Coverage	5.9 x	4.3 x
Earnings Variance—Past 10 Years	23.4%	81.8%
S&P Stock Ranking (A+, A, A-)	30.0%	15.0%
Growth		
Earnings Per Share Growth—Past 10 Years	14.6%	5.8%
Dividend Per Share Growth—Past 10 Years	8.6%	5.2%
Capital Generation—(ROE x {1-Payout})	14.3%	8.3%
Value		
P/E Ratio—Trailing 12 Months	15.1 x	16.1 x

Data is obtained from Bloomberg, FactSet Research Systems, and a major consulting firm, and is assumed to be reliable. Other principal consultant firms may use different algorithms to calculate selected statistics. Data is as of June 30, 2008.

As always, we endeavor to manage your portfolio with the highest quality businesses, outgrowing their markets, purchased at discount values.

The Russell 2000® Value Index consists of those Russell 2000® Index companies with lower price-to-book ratios and lower forecasted growth values. The S&P 500® Index is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The Russell Midcap® Index consists of the smallest 800 securities in the Russell 1000® Index, as ranked by total market capitalization. The Russell 2000® Index measures small-company stocks. Performance is calculated on a total-return basis with dividends reinvested. These indexes are unmanaged and not available for direct investment.

This report is based on the assumptions and analysis made and believed to be reasonable by Adviser. However, no assurance can be given that Adviser's opinions or expectations will be correct. This report is intended for informational purposes only and should not be considered a recommendation or solicitation to purchase securities. A complete list of holdings and specific securities transactions for the preceding 12 months is available upon request. Holdings are subject to change. Past performance is no guarantee of future results.

Form ADV, Part II is available upon request. Please contact us or visit our Web site, www.kayne.com.