Framework - Risk

"Suppose a man leaps from an airplane without a parachute...he faces no risk. Risk requires both exposure and uncertainty." – Glyn Holton

Many investors regard the word risk in the negative; "How much can I lose?" JP Morgan delivers its VaR (Value at Risk) metric in the context of "VaR calculates the worst expected loss over a given horizon at a given confidence level under normal market conditions." In that vein, investors will employ certain strategies to control and mitigate as much downside risk as possible. It's a statistical fact that protecting the downside is worth slightly more than freeing the upside. Here's a little experiment to prove that it's true. Assume you begin with $1 in an investment. Go ahead and put alternating returns of +10% and -10% for ten periods (or however long you want). Your investment will never recover the losses generated by the erosion of capital, even though your average return will be 0%!

Ultimately, risk represents the chance that our expectations are not met. We would like to share with you how we view risk in the context of our Value Zone®. Our Value Zone framework is driven by three primary considerations in building our portfolios. First, there is the Company Risk associated with the companies that we own over a three- to five-year horizon. Second, there is the Price Risk associated with the stocks of those companies. We believe that in the short term, those two items may be completely uncorrelated, but that over time, good companies will garner good prices. Finally, the practice of Risk awareness and control,should provide a portfolio that outperforms the benchmark over that three- to five-year period.

Company Risk—the operational risk of any potential investment—is often difficult to describe. Warren Buffet has often addressed this concern with a subjective claim for companies that have a "moat" around their business, some competitive advantage that can protect it. A fellow named Edward Altman came up with the Z-score in 1968 in an attempt to objectively quantify financial risk – or risk of bankruptcy by using a quantitative model. S&P, Moody's, and Fitch also have models that help score the financial risk of various companies and instruments. All of these models are based on historical trends, designed to assign some probability that an entity will go kaput!

At Pacific Ridge, we use a combination of subjective and objective measures to assess the operational and financial risk of the companies we invest in. As equity investors, our measures focus on the three drivers of Return on Equity: Sales, Profit Margin, and Leverage. The simple question that we are attempting to answer is: over a three- to five-year period, what earnings can we reasonably expect a company to generate? To do this, we overlay some basic assumptions about overall economic growth rates, raw material and wage inflation, interest rates, and the overall liquidity of the capital markets. We want to find profitable companies earning a positive return on their capital.

It is our nation's happy experience that the vast majority of publicly traded companies are earning a profit (80% of the companies in the Russell Indexes reported operating profit in the latest twelve month period). Approximately 75% of companies are earning a profit after their interest payments. And this year, nearly 70% of all reporting companies are generating cash after spending capital expenditures and making allocations to working capital. In terms of actual bankruptcy, it's fairly remote. In fact, only about 3% of publicly traded companies filed for bankruptcy in each of the last two years (86 each year) according to Bankruptcydata.com. That's a good start to putting the odds in your favor – certainly better than a coin flip, and we like the odds stacked in our favor.

Next, we have to determine who gets to divvy up the profits. Generally speaking, for unlevered firms, equity holders have the first claim on residual cash flows from a business. For levered firms, however, debt holders have a call option on the value of the firm that must be satisfied before equity holders get anything. It is important because if the Total Enterprise Value is not enough to cover the claims of creditors, then equity holders will be left with nothing. We term this default risk.

Our experience tells us that the market will oftentimes over price the risk of default of companies, creating good buying opportunities. Using a combination of quantitative performance measures (like a Z-score) does give us insight into the probability of default and bankruptcy. At times, however, other measures, such as the tightness of credit markets, are helpful. For an explanation of that, see our letters dated October 2010 and August 2011.

We then employ a combination of stress test scenarios to determine the possible range of operating outcomes that a company may produce. That analysis is independent of the market's view of the company's value. It either generates a return on its capital or it does not. After determining that a company is a good company, the merits of its attraction become a matter of price.

We will pick up the second and third legs of our Risk Framework in our second and third quarter letters, which we hope you will read.

We would also like to add a short note on last quarter's commentary. Birth rates in the United States have continued to fall, and according to the most recent release from CDC, the preliminary birthrate data for 2011 suggest the lowest recorded birthrate in US History. Jonathan Last, of the Weekly Standard, has done an admirable job of providing some very insightful facts and interpretations of the current trend. An essay adapted from his new book was published in the Wall Street Journal on February 2, 2013. We encourage you to take a look.

Sincerely,

Pacific Ridge Capital Partners

Pacific Ridge Capital Partners, LLC 4949 Meadows Road Suite 125 • Lake Oswego, OR 97035 • 503.886.8970 • www.PacificRidgeCapital.com

Small Cap Value Portfolio Statistics (as of Sep'12)

	PRCP Small Cap Value	Russell 2000® Value
Number of Holdings	119	1,406
Average Market Cap ($M)	373.8	647.7
Weighted Average Market Cap ($M)	392.1	1,106.0
Median Market Cap ($M)	327.3	436.4
Price/Earnings (FY1)	13.5	13.8
Price/Earnings (FY2)	10.9	12.5
Price/Book	1.3	1.2
Dividend Yield	1.4%	2.2%
Beta (vs Russell 3000)	1.4	1.3
L.T. Growth Forecast Median	12.2%	10.6%

Micro Cap Value Portfolio Statistics (as of Sep'12)

	PRCP Micro Cap Value	Russell Microcap® Value
Number of Holdings	68	1,047
Average Market Cap ($M)	192.5	204.9
Weighted Average Market Cap ($M)	198.2	302.2
Median Market Cap ($M)	162.6	175.0
Price/Earnings (FY1)	14.8	13.8
Price/Earnings (FY2)	11.6	12.2
Price/Book	1.1	1.0
Dividend Yield	1.0%	1.9%
Beta (vs Russell 3000)	1.4	1.3
L.T. Growth Forecast Median	15.0%	11.0%

Composite Performance Tables

Small Cap Value

	Q3'12	YTD	1 Year	Since Inception
PRCP Small Cap Value, Gross (%)	3.8	17.0	37.8	11.7
PRCP Small Cap Value, Net	3.5	16.2	36.4	10.6
Russell 2000® Value	5.7	14.4	32.6	11.9

Micro Cap Value

	Q3'12	YTD	1 Year	3 Year	5 Year	Since Inception
PRCP Micro Cap Value, Gross (%)	4.8	22.3	44.3	16.3	5.8	4.1
PRCP Micro Cap Value, Net	4.5	21.0	42.3	14.6	4.3	2.6
Russell Microcap® Value	5.7	20.3	37.4	11.4	(0.8)	(1.7)

The Firm maintains composites on both its strategies. The Small Cap Value Composite incepted on August 1, 2010. The Micro Cap Value Composite incepted on April 1, 2007. All returns greater than one year are annualized. The performance results of the Micro Cap Value strategy includes accounts managed at another advisor. The Firm maintains a complete list and description of composites and a presentation that complies with the requirements of GIPS® standards, which is available upon request by contacting Peter Trumbo, Chief Compliance Officer at (503) 886-8972 or Peter.Trumbo@PacificRidgeCapital.com. The portfolio statistics are shown as supplemental information only and complements the full disclosure presentation (fully compliant GIPS presentation).

Pacific Ridge Capital Partners, LLC 4949 Meadows Road Suite 125 • Lake Oswego, OR 97035 • 503.886.8970 • www.PacificRidgeCapital.com

About Pacific Ridge Capital Partners, LLC

Pacific Ridge Capital Partners is an employee-owned firm. We generate our own investment ideas using fundamental analysis and bottom-up stock picking. The investment team applies a consistent, patient and disciplined process that results in low turnover and stability. Our proven philosophy has performed well over many investment cycles and it is the consistent application of this strategy that makes Pacific Ridge unique.

The principals of Pacific Ridge Capital Partners are invested along with our clients in each of our strategies.

PRCP Small Cap Value – Our Small Cap Value strategy generally purchases stocks in the bottom three-quarters of the Russell 2000® Index. This smaller capitalization segment has a large number of underfollowed companies, providing us the greatest opportunity to exploit market inefficiencies. The typical range of holdings is between 120 and 160.

PRCP Micro Cap Value – Our Micro Cap Value strategy generally purchases stocks in the Russell Microcap® Index. This segment is widely underfollowed, providing us the greatest opportunity to exploit market inefficiencies. The typical range of holdings is between 50 and 80.

We believe these market cap segments offer great potential returns and additional diversification for our clients.

For further information about Pacific Ridge Capital Partners and our investment strategies, we invite you to contact Peter Trumbo via email at Peter.Trumbo@PacificRidgeCapital.com or by phone at (503) 886-8972.