

Small/Mid Cap Equity Comments—1st Quarter 2012

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Small- and mid-cap equities had another quarter of strong performance, following the sharp rally off of the October lows of last year. Over the last six months, the Russell 2500 Index is up over 25%. This partly reflects how oversold stocks were in early October, but also the steady flow of incrementally better macroeconomic news. Employment, income and housing data in the U.S. have improved, albeit modestly. The worst of possible European outcomes – a meltdown of the financial system and government balance sheets – appears remote with stop-gap funding in place. Equities have reacted positively to at least some near-term risk being mitigated.

The Small/Mid cap Equity portfolio continued to perform well in the rally, rising more than the Russell 2500 and Midcap Indices over the first quarter. The portfolio has now exceeded the Russell 2500 Index in seven of the last eight quarters. The majority of sectors contributed to the positive result this quarter, but relative performance was led by the three strongest sectors so far this

year: financials, consumer discretionary and technology.

Financials have been rallying since the fourth quarter of last year and were a favored group by investors in the first quarter. Global investment company Invesco Ltd. had the biggest contribution, driven by rising capital markets, good product performance and increasing fund flows. Commercial real estate holdings Jones Lang LaSalle Inc. and CBRE Group Inc. were also strong performers, having rebounded sharply from the lows of September. We have had two strong performers in the payment processing arena, FleetCor Technologies Inc. and Wright Express Corp., which provide specialized payment networks for commercial fleets and online travel among other things. We anticipate both could potentially grow earnings this year nearly 20%.

The consumer discretionary sector has also continued to charge ahead as spending trends have remained resilient during what

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has thus far been a meager recovery. Modest gains in employment and income, a significant recovery in capital markets and the potential bottoming of the housing market have all contributed to solid spending trends. Watchmaker Fossil Inc. had a sizeable gain in the first quarter as worldwide watch growth remains high, international business was resilient and the company made an accretive acquisition. In footwear and apparel, Foot Locker Inc., Express Inc., and PVH Corp. (Philips Van Heusen) were all top performers with each having significant product momentum. Auto supplier BorgWarner Inc. rose on a good quarterly report and is benefiting from a rebound in auto production around the world. Importantly, BorgWarner is growing well above the industry pace by providing components to increase fuel efficiency and reduce emissions. The top contributor in the portfolio this quarter was Select Comfort Corp., the air mattress maker and retailer. Specialty mattresses are rapidly gaining market share from traditional spring mattresses and this trend has accelerated in the first three months of the year. We boosted exposure to the consumer

discretionary sector over the first quarter, adding positions BJ's Restaurants Inc., shoe retailer DSW Inc., and beauty supply retailer Sally Beauty Holdings Inc.

The health care sector was the only notable detractor from relative performance this quarter. While our performance was positive, we were not exposed to the early-stage biotechnology companies that had some of the sharpest upward moves. Our focus is on companies with more proven products and business models. We had only one holding that was particularly weak, IPC The Hospitalist Co. Inc. The company provides hospital staffing, taking on the administrative function. The company preannounced a negative earnings surprise in January, based on staffing-related costs and issues. We have sold the position. We added Amylin Pharmaceuticals Inc., a diabetes drug producer, to the portfolio this quarter. Bristol-Myers Squibb subsequently made an offer to buy the company at a substantial premium. While the offer was rejected, Amylin stock rose over 50% in one day and was one of the top performing stocks in the portfolio this quarter.

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The technology sector was both a good area within the market and a positive sector for portfolio relative performance. Fear over information technology budgets and the level of inventory in the second half of 2011 pressured the sector into the end of the year. However, earnings estimate concerns were overdone and the sector rebounded in the first quarter as the reality of better underlying demand trends emerged. We had several strong contributors including Avago Technologies Ltd., a semiconductor producer, and software makers Informatica Corp. and Red Hat Inc. The top contributor in the sector was ACI Worldwide Inc., which provides payment systems for financial institutions that facilitate electronic processing. Payment processing is rapidly evolving to include alternative payment channels and mobile capabilities; thus, we believe growth in this area should remain robust and will continue to provide investment opportunity.

Gross Expense Ratio for Original Shares is 1.24% and for Institutional Shares is 0.99%.

Opinions expressed are subject to change, are not guaranteed and should not be considered investment advice.

For a listing of holdings current to the most recent quarter end, please [click here](#). Fund holdings and sector allocations are subject to change at any time and are not a recommendation to buy or sell any security. **Current and future portfolio holdings are subject to risk.**

The Russell 2500 Index measures the performance of the 2,500 smallest companies in the Russell 3000 Index, or about 19% of its total capitalization. The Russell Midcap Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index. One cannot directly invest in an index.

Mutual fund investing involves risk. Principal loss is possible. Mutual fund investing involves risk. Principal loss is possible. Small- and medium-cap companies tend to have limited liquidity and greater price volatility than large-cap companies. Investments in foreign securities involve greater volatility and political, economic and currency risks and differences in accounting methods.

Earnings growth is not a measure of the fund's future performance.

The Funds investment objectives, risks, charges and expenses must be considered carefully before investing. The summary and statutory prospectuses contain this and other important information about the investment company, and may be obtained by calling 800.536.4640 or by visiting www.rainierfunds.com. Read carefully before investing.

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