

Morgan Dempsey Small/Micro-Cap Value - Second Quarter Commentary

Sea of Tranquility

Economic Perspective

Some 40 years ago, on the night of July 20, 1969 at 8:17:40 PM GMT, astronaut Neil Armstrong stepped off the lunar module *Eagle's* ladder onto the surface of the moon in the "Mares Tranquillitatis." "One small step for man, one giant leap for mankind" brought closure to the space race with the Soviets, honored a dead President's promise and ushered a closure to the volatile civil unrest of the 1960s on a positive note. Fast forward forty years, we sail into the "summer doldrums" following a convulsive deflationary global credit crisis which began to unravel last July in sub-prime/Alt-A mortgage loans.

The stock market fluctuates between the natural reflationary exodus of a credit crisis plus a \$787 billion stimulus and potentially harmful business policies being floated in Washington. The key issue the Administration needs to realize is that: when the federal government fosters an environment which punishes and penalizes capital through higher tax liability, allows deficit spending to crowd private capital formation, initiates pro-active reregulation and permits the specter of Federal, State and Municipal government spending to approach 40% of GDP, it yields to an economy punctuated by low productivity, capital flight, depreciating sovereign currency (\$dollar) and volatile cyclicity between expansion and recessions. Furthermore, capital and technology cross sovereign borders with impunity and productivity or capital flight from the U.S. means resources for China, Brazil, India and Russia. Free floating markets warrant price discovery rather than disruption by a government intervention safety net. Lowering the price of risk assumption and building incentives for capital formation will stimulate risk exposure and drive growth, the only viable tact to build tax receipts (Hauser's Law).

Performance Summary

| | Morgan Dempsey Small-Cap (Net) | Russell 2000 Value |
|-------|--------------------------------|--------------------|
| April | 13.08% | 15.87% |
| May | 2.55% | 2.16% |
| June | -1.15% | -0.32% |
| Q2 | 14.62% | 17.99% |
| YTD | 2.65% | -5.17% |

Account Information

Management Fee: 1.00%
Minimum Investment: \$1,000,000
No lockup period or redemption restrictions

Manager Information

Brian G. Rafn
Director of Research/Portfolio Manager

Mr. Rafn joined Morgan Dempsey in October of 2003. He has over 20 years of experience in securities analysis, portfolio management, trading and trust accounting. Brian additionally has degrees in Finance, Accounting and Economics.

Portfolio Information

Top 10 holdings as of 6/30/09

| | |
|-------------------------------------|------|
| 5.4% - Aptar Group, Inc. | ATR |
| 5.2% - Granite Construction, Inc. | GVA |
| 5.0% - National Presto Ind. | NPK |
| 5.0% - Jos. A. Bank Clothiers, Inc. | JOSB |
| 5.0% - J&J Snack Foods Corp. | JJSF |
| 4.5% - Utah Medical Products, Inc. | UTMD |
| 3.8% - Gorman Rupp Co. | GRC |
| 3.0% - L.B Foster Co. | FSTR |
| 2.2% - Flower Foods, Inc | FLO |
| 2.2% - Sturm Ruger & Co. | RGR |

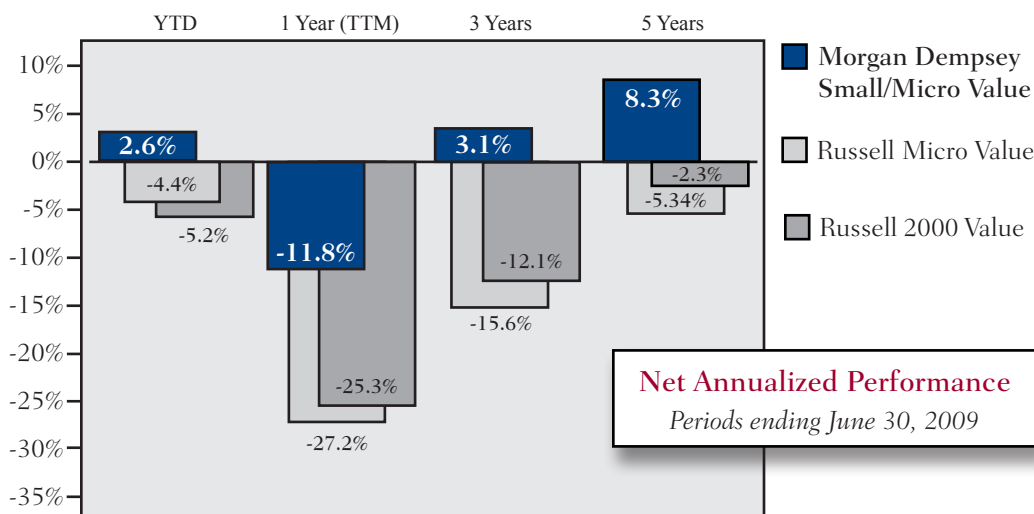
Total Number of Holdings: 68
1 year turnover: 35%
Median Market-Cap: \$437 million
Weighted Market-Cap: \$650 million

Contact Information

Morgan Dempsey Capital Management, LLC
309 N. Water Street
Milwaukee, WI 53202
www.MorganDempsey.com

For additional information or a copy of our ADV part II please contact:

Maury McCoy
Phone: (512) 775-0944
E-mail: Maury@McCoy-Associates.com





The American government has committed to a “social agenda” during a period which, in our opinion, requires a stronger focus on the economy. In contrast, we spend material time in dialogue with our founder/owner/operator managed business partners (common stocks) who voice the conservative anthem of savings, fiscal austerity, low tax liability, incentives, accelerated depreciation schedules, fair value wages/ benefits for labor and an optimism of investment in the American economy.

Of concern to us as investors is the current agenda which could have a material impact on portfolio strategy and investment policy as applied to:

1. Misallocation of capital based not on rates of return on capital but political agendas.
2. Accumulation of accelerating federal government debt (\$11.6 trillion) at 81.14% of GDP, void of any investment in tangible assets which yields cash flow to service the debt.
3. Focus on Cap & Trade global pollution ecology, national healthcare, Guantanamo Bay terrorists in prison and minimum wage bills, while infrastructure, national defense, border sovereignty and international conflict, trade and issues of real substance suffer malaise.
4. Reregulation (anti-trust) restricts innovation, productivity, capital flows and the appetite for risk exposure and depresses sentiment which lowers capitalized multiple assignments (P/E, P/EBITDA, P/E, free cash flow yield %) on (equity) sales, cash flow and earnings.

This political intervention can serve as a ceiling and limitation on the rebound capacity of equity prices. We have, however, observed a building pro-growth, pro-business, pro-tax payer posture as the maverick nature of American capitalism is exhibited in regional tax revolt “Tea Party” protests, California state budget resolutions and higher media attention to surplus budget states such as Indiana and South Dakota.

The economic report card in the U.S. is mixed with unemployment approaching 9.6%, a savings rate rebounding to 7%, the ECI employment cost index at +2.1% vs. 3.3%, MZM money supply velocity (turnover) declining to 1.56x, the Federal Reserve balance sheet holding at \$2.143 trillion, oil inflating to \$70+ spot as natural gas is collapsing to \$3.487 MMBTU, an early drought pressuring grain stocks in the Great Plains, and the vast majority of state and county/municipal budgets operating at deficits.

The sentiment recovery of avoiding a deflationary spiral, forms the foundation of the next bull market cycle and in part yields some support to the depressed consumer consumption in the U.S. (72% GDP 2007). Homebuilding construction measured by new starts rebounded to 538,000 units in June (vs. 315,000 January-March 2009), inventory de-stock in auto sales rebounded in May-June 2009 to almost 10,000,000 units and the general inventory pipeline de-stocking is illustrating evidence of order and stockpile building in the 3rd and 4th quarter of 2009. Growth stock investing, specifically technology sector performance, exhibited the leadership driver for the second quarter of 2009 with the reflation of “animal spirits” (risk) also favoring healthcare and consumer cyclicals.

Portfolio Review

Our portfolio performed admirably in the second quarter posting a +14.6% gain and bringing our YTD performance into positive territory (+ 2.64%) compared to a -5.17% YTD return for our index the Russell 2000 Value. Stress on the P&L income statement and earnings power continues to be the result of 15%-40% declines in sales revenue coupled with higher (debt) interest cost and episodic pension liability deposits. As we navigate through the quarter’s 10-Q and press releases, PP&E capital expenditures budgets amongst our companies still track at 80%-110% of depreciation and amortization.

At a 30,000 foot view, the 2nd quarter exhibited modest sector shifts in our portfolios, with Consumer Cyclicals 14.6% vs. 12.7%, Materials 11.8% vs. 13.4%, Energy 9.6% vs. 6.4%, Technology 7.9% vs. 6.9% and



Consumer Staples 16.5% vs. 19.0% as measured by June 30 vs. March 31, 2009 quarter dates.

The portfolio issue tilts, our highest conviction ideas we refer to as the Locomotive 7 (4%-8% weights), posted 6 of 7 stocks with positive total returns ranging at +1.87 to +24.73%. The portfolio posted capital gains from ATRION Corporation +51.96%, Bar Harbor Bankshares, Inc. +32.40%, Badger Meter, Inc. +42.92%, Columbus-McKinnon, Inc. +45.07%, Cubic Corporation +41.29%, Dril-Quip, Inc. +24.10%, Dawson Geophysical Company +121.11%, Graham Corporation +48.27%, Gulf Island Fabrication, Inc. +97.63%, Jos A Banks Clothiers, Inc. +23.91%, Lakeland Industries, Inc. +51.20%, Hawkins, Inc. +46.34%, National Presto Industries, Inc. +51.20% and Unit Corporation +31.79%. Performance was driven by 29 common stocks posting higher 2009/2008 1Q earnings comparisons and 16 companies generating earnings growth >12%.

Share price erosion in a few of our defensive hedges from 2008 countered our gains with Flower Foods, Inc. down -7.0%, United Fire and Casualty Company -22.6% and our top locomotive holding Granite Construction, Inc. declining -11.2%.

Latent anxiety about the 15% fiscal budget deficit (\$110 billion state budget) of the world's 7th largest economy, the state of California, pressured shares of Granite Construction (Watsonville, CA). The next 6 year highway bill to replace SAFE-TE-LEU (September 30, 2009) is forecast to expand 70% from the \$286.6 billion current base. The present legislation meandered through Congress for 26 months which prompted partial funding and fosters anxiety of a repeat. We applaud the Obama Administration's support for the Federal Infrastructure Bank initiative which would alleviate some of these concerns. Classic to our contrarian style, CALTRANS (D.O.T.) announced a record \$4.6 billion funding of 422 state transit projects which have been certified, obligated and funded with aid from a \$2.57 billion stimulus contribution.

Granite Construction operates as the largest California based C&E contractor, no. 21 ranked in the U.S. and the no. 4 contractor as a pure play in transit

infrastructure only. With a legacy dating to 1922 (87 years), an 8% cost benefit with vertical integration in owning gravel/stone quarries and existing as only 1 of 6-8 "design build" integrators, the shares are priced at only 9.8X EPS for '09 at \$3.47. We believe shares of Granite Construction represent the best single "pure transit" play in infrastructure with a fortress balance sheet and empowered labor force.

Cubic Corporation is a defense electronics and mass transit conglomerate we have owned since 1999 which is controlled by the Zabel family in San Diego. The company designs, constructs and installs training and combat simulators for aviators, tankers, soldiers and spec-op commandos; jobs of a peace time military. Cubic also builds turnstile fare collection gateways for trains, subways, mono-rails and public bus terminals - a sweet spot in the stimulus planning. Since the 2006 profit of \$.90 in EPS, the earnings power growth rate accelerated to +26.8%, keyed off of a next generation installation of training simulators which apply "real world" scenarios from Cubic employees stationed in Afghanistan and Iraq with the U.S. military.

Lakeland Industries, Inc. (LAKE) represents our portfolio insurance against CBR terrorist (chemical, biological, radiation) attacks and operates as an OEM manufacturer of HAZ-MAT suits for first responders. The company additionally operates a base business which services protective suits (TYVEK) for industrial, healthcare and technology clean rooms. The common stock trades at \$7.83 with earnings estimates (E) of \$.67 for 2010 and a forward looking \$.90 for 2011. This is under a 10X multiple with material global 911 disaster response insurance for free.

Felix Rohatyn (80) a democratic advisor from New York and a Managing Director of Lazard Freres Cos, in his recent book *Bold Endeavors* highlights the tenacity and fortitude with which past American Presidents have built the U.S. infrastructure during periods of trepidation. In 2008/2009 the Army Corps of Engineers estimated the U.S. infrastructure rebuilding project to approximate \$1.6-\$2.2 trillion for highways, bridges, canals, dams, railroad line yards, marinas, airports, subways, electric grid, oil and gas pipelines



and pumping rigs, water/sewage and quasi military installations (ports, bases, border fences, electronic security, cyber warfare). On a separate infrastructure network, the American Power Association estimates the U.S. requires a \$1.0 trillion investment in the electric power grid to erect or renovate transmission lines, power plants and relay hubs.

Felix reminds us Thomas Jefferson purchased the Louisiana Territory from Napoleon Bonaparte in 1803 while deliberating its constitutionality. Abraham Lincoln supported the transcontinental railroad in the 1860's during the Civil War. Theodore Roosevelt built the Panama Canal and the Great White naval fleet following the depression of 1873, 1893 and the Panic of 1907. Franklin Delano Roosevelt sponsored rural electrification and the Hoover Dam/Tennessee Valley Authority during the Great Depression 1930-1938. His modern examples focus on Dwight Eisenhower during the 1950's Cold War with the Soviets building the interstate highway system in 1954-1959 and Ronald Reagan's military spending (600 ship U.S. Navy, MX missiles, Pershing theatre IRBM, F-117 stealth fighter, etc.) which forced the USSR into the "dust bin of history" following a savage 1980-1982 recession and stagflation of the 1970's.

The foundation of our small/micro-cap value strategy during the early millennium 2000-2020, continues to focus on rebuilding and upgrading the infrastructure network from which a commercial economy prospers and directs tax receipts to the government to service the debt of construction.

This investment (capital formation) creates jobs and cash flow to lubricate an economy which continues to suffer from consumer spending peaking at 72% in 2007 and reverting to the potential mean 63%-64% (1995-2000) level forward. This "consumption gap" currently approximates \$1.368 trillion per year and mandates either investment spending (I) or reflation of exports to bridge the 8%-9% GDP gap lost from lower consumption spending. We are cautious of the developing commercial real estate weakness as vacancy, capitalization rates and loan delinquencies expand while income yield, property values and M&A deal volumes decline.

Also on our radar is the appetite of China to secure strategic raw materials (source supply chains) for its industrial base, contrary to the history of Imperial Japan during the 30's and the lesson of defeat during World War II. Furthermore, the politicalization of the Federal Reserve and super regulator mission change along with discussion of a Bernanke removal trouble our sentiments. We believe the public sector should return to the traditional support as regulator and exit private sector ownership, divorce ideas of anti-trust litigation, "green job" ecology, VAT tax passage, healthcare reform and cap & trade pollution control. Cash flow disintermediated to fund these programs robs funding from national defense, infrastructure, energy policy, law enforcement, anti-terrorism and education.

Our portfolios hold 15 common stocks or 25.4% (June 30, 2009) of capitalization which are positioned to leverage this non-cyclical and bi-partisan political necessity of infrastructure repair and rebuild.

The ignition of economic growth is paramount, via sound fiscal and monetary policy, tax liability reduction of marginal rates on capital gains and dividends, payroll tax holidays, free repatriation of offshore profits from tax, SBA loans and accelerated depreciation schedules. These all form a vanguard of pro-growth policy. A 2nd stimulus transfer payment or social engineering is a bankrupt 1930's policy (\$787 billion+ \$400 billion + \$170 billion) of which as of this writing only 7% of \$787 billion is circulating.

As the stock market focuses and overemphasizes the importance of earnings and cash flow, while it ignores the long-term solvency of balance sheets, so it was 40 years ago. The world's TV cameras trained on Neil Armstrong and Buzz Aldrin as they tread the grayish dust of the moon, while the ignored and silent command module *Columbia* orbited with Colonel Michael Collins to provide the 252,687 mile ride home. The balance sheet has been, and continues to be, at the core of our research efforts and we remain diligent to insure that our ship is sound for the long journey ahead.

Morgan Dempsey Capital Management Investment Performance Disclosures



1. Compliance Statement: Morgan Dempsey Capital Management, LLC has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®). 2. Definition of Firm: Morgan Dempsey Capital Management, LLC is an independent investment management and advisory firm registered under the Investment Advisors Act of 1940. MDCM was established in 1994. The assets reflected in this investment performance beginning with the 3rd quarter 2002 were managed by Brian Rafn, V.P portfolio manager, director of research of MDCM. 3. Composite Description: The small cap value equity composite includes all fully discretionary, fully invested, fee-paying accounts that are managed in the firm's small cap value equity model. The composite includes only U.S. small cap value stocks. The composite does not include any accounts which employ leverage, nor does it include any wrap accounts. The minimum account size for inclusion into the small cap value equity composite is \$100,000.00. 4. Benchmark: For comparison purposes, a benchmark of the Russell 2000 Value Index is used. The Russell 2000 Value Index is constructed to provide a comprehensive and unbiased barometer of the small-cap value market. Based on ongoing empirical research of investment manager behavior, the methodology used to determine growth probability approximates the aggregate small-cap value managers opportunity set. Securities in the Value Index generally have a lower price-to-book and price-earnings ratios than those in the Growth Index. 5. Calculation Methodology: The composite performance results are net and gross of fees and are expressed in U.S. Dollars for the full historical period. They are time-weighted rates of return presenting total returns, net of commissions and transaction costs. Performance results reflect the reinvestment of dividends and other earnings and are presented gross and net of investment management fees and taxes. Additional information regarding the policies for calculating and reporting returns is available upon request. 6. List of Composites: The composite was created June 30, 2002. A complete list

and description of firm composites is available upon request. 7. Total firm assets represent total discretionary assets managed by MDCM. The number of portfolios in the composite is as of year end. The quarterly standard deviation is calculated as the average dispersion from the mean return of all accounts included in the Composite for the quarter. The annual standard deviation is the calculated average dispersion of accounts in the Composite for the full year. Note 1:n/a (<5 portfolios). During 2002 and the first quarter of 2003 results relate to one account and the account used was not the same from year to year. 8. The above table reflects past performance. Past performance does not guarantee future results. A client's investment return may be lower or higher than the performance shown above. Clients may suffer an investment loss. Returns reflect the reinvestment of dividends and other earnings. 9. Gross performance result calculations include the deduction of securities transaction charges but not investment advisory fees. The results include the reinvestment of all dividends and other income. Actual portfolio returns are reduced by the amount of such fees. Over time, the deduction of fees reduce the value of a portfolio on a compounded basis. 10. Net performance result calculations include the deduction of securities transaction charges and investment advisory fees. The results include the reinvestment of all dividends and other income. 11. Historical net performance numbers are calculated using the highest management fee charged by MDCM. (1.00%). 12. Fees: Standard management fees for the composite are as follows: first \$10,000,000=1.00% MDCM will negotiate fees for a structured small account program. MDCM will negotiate fees for accounts of substantial size. 13. Percentage of composite represented by non-fee paying accounts = 0.00%. 14. One-on-One Presentation: This report is used exclusively for one-on-one presentations to qualified individuals, pension funds, universities and other institutions. 15. The information herein is for informational use only. Under no circumstances does this information represent a recommendation to buy or

| Year | # of Portfolios | Composite Assets | Firm Assets | Composite Dispersion | Composite Gross of Fees | Composite Net of Fees | Benchmark Performance |
|---------|-----------------|------------------|--------------|----------------------|-------------------------|-----------------------|-----------------------|
| 2003 | 1 | 363,200 | 137,315,376 | 0.00 | 32.87 | 31.68 | 46.03 |
| 2004 | 3 | 2,225,425 | 72,707,427 | 0.00 | 23.82 | 22.59 | 22.25 |
| 2005 | 6 | 3,140,055 | 68,492,815 | 0.95 | 16.60 | 15.47 | 4.71 |
| 2006 | 7 | 3,904,553 | 190,286,996 | 0.20 | 19.73 | 18.55 | 23.48 |
| 2007 | 8 | 4,556,445 | 186,950,509 | 0.43 | 11.94 | 10.83 | -9.78 |
| 2008 | 10 | 4,642,480 | 145,295,212. | 2.37 | -13.11 | -13.99 | -28.93 |
| YTD '09 | 10 | 4,849,240 | 154,599,617 | 0.48 | 3.17 | 2.65 | -5.17 |

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